

FIRST NATIONAL CORP /VA/
Form 10QSB
May 15, 2003

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

[x]

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

For the quarterly period ended MARCH 31, 2003

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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

FIRST NATIONAL CORPORATION

(Exact Name of Registrant as Specified in its Charter)

VIRGINIA

54-1232965

(State or Other Jurisdiction
of Incorporation or Organization)

(I.R.S. Employer Identification No.)

112 WEST KING STREET, STRASBURG, VIRGINIA 22657

(Address of Principal Executive Offices)

540-465-9121

(Registrant's Telephone Number, Including Area Code)

N/A

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

Indicate by check 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 .

As of May 11, 2003, the number of outstanding shares of registrant's common stock, par value \$5.00 per share was: 731,031.

PART I. FINANCIAL INFORMATION

Item 1.

FINANCIAL STATEMENTS**FIRST NATIONAL CORPORATION****Consolidated Balance Sheets**

(In thousands of dollars except share data)

	(Unaudited)	(Audited)
	March 31,	December 31,
ASSETS:	2003	2002
Cash and due from banks	\$ 10,891	\$ 14,920
Federal funds sold	10,889	2,791
Securities available-for-sale, at fair value	53,143	54,485
Loans held for sale	381	1,348
Loans, net of allowance for loan losses of \$2,261 and \$2,162	219,619	210,440
Bank premises and equipment, net	8,869	8,424
Accrued interest receivable	1,245	1,403
Other assets	2,672	2,125
Total assets	\$ 307,709	\$ 295,936
LIABILITIES:		
Deposits		
Non-interest bearing demand deposits	\$ 40,973	\$ 36,581
Savings and interest bearing demand deposits	110,056	107,119
Time deposits	102,753	99,312
Total deposits	253,782	243,012
Long-term debt	26,593	26,605
Trust preferred capital notes	3,000	--

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Accrued expenses and other liabilities	2,302	2,065
Total liabilities	285,677	271,682
STOCKHOLDERS EQUITY:		
Common stock; par value \$2.50 per share; authorized 4,000,000 shares; issued and outstanding 1,462,062 shares March 31, 2003 and 1,580,062 shares December 31, 2002 *	\$ 3,655	\$ 3,950
Surplus	1,465	1,465
Retained earnings	15,971	17,659
Accumulated other comprehensive income	941	1,180
Total stockholders equity	22,032	24,254
Total liabilities and stockholders equity	\$ 307,709	\$ 295,936

Notes to consolidated financial statements are an integral part of these statements.

*Restated to give retroactive effect to two for one stock split declared on April 16, 2003 and payable as of May 30, 2003.

FIRST NATIONAL CORPORATION**Consolidated Statements of Income**

(In thousands of dollars except per share data)

(Unaudited)

	Three Months Ended	
	March 31,	
	2003	2002
INTEREST AND DIVIDEND INCOME:		
Interest and fees on loans	\$ 3,699	\$ 3,499
Interest on federal funds sold	15	36
Interest on deposits in banks	10	7
Interest and dividends on securities available for sale:		
Taxable	504	460
Nontaxable	72	77
Total interest and dividend income	4,300	4,079
Interest on long-term debt	406	430
Total interest expense	1,775	1,864
Net interest income	2,525	2,215
		90
Provision for loan losses	158	
Net interest income after		
provision for loan losses	2,367	2,125
NONINTEREST INCOME:		
Service charges and other fees	527	241
Gains on sale of securities	16	70
Gains on sale of loans	80	37

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Other	182	171
Total non-interest income	805	519

NONINTEREST EXPENSE:

Salaries and employee benefits	1,030	793
Occupancy expense	128	114
Equipment expense	179	134
Advertising	73	64
Professional Fees	72	41
Other operating expense	583	474
Total non-interest expenses	2,065	1,620
Income before income taxes	1,107	1,024
Provision for income taxes	363	322
NET INCOME	\$ 744	\$ 702

EARNINGS PER COMMON SHARE,

basic and diluted *	0.49	0.45
CASH DIVIDENDS PER COMMON SHARE*	0.19	0.17

AVERAGE COMMON SHARES OUTSTANDING,

BASIC AND DILUTED *	1,534,173	1,580,062
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Notes to consolidated financial statements are an integral part of these statements.

*Restated to give retroactive effect to two for one stock split declared on April 16, 2003 and payable as of May 30, 2003.

FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Stockholders Equity

For the three months ended March 31, 2003 and 2002

(In thousands of dollars)

(Unaudited)

	Common		Retained	Accumulated Other Comprehensive		Total
	Stock	Surplus	Earnings	Income (Loss)	Income	
Balance, December 31, 2001	\$3,950	\$ 1,465	\$ 15,770	\$ 415		\$21,600
Comprehensive Income:						
Net income	--	--	702		\$ 702	702
Other comprehensive income, net of tax						
Unrealized holding gains (losses) on securities available-for-sale arising during the period (net of tax of \$38)					75	
Reclassification on adjustment (net of tax of \$24)					(46)	
Other comprehensive (loss) income (net of tax of \$62)	--	--	--	(121)	(121)	(121)
Total comprehensive income					\$ 581	
Cash dividends declared	--	--	(269)	--		(269)
Balance, March 31, 2002	\$3,950	\$1,465	\$16,203	\$ 294		\$ 21,912

Accumulated

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	Common Stock	Surplus	Retained Earnings	Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2002	\$ 3,950	\$ 1,465	\$ 17,659	\$ 1,180		\$ 24,254
Comprehensive income:						
Net income	--	--	744		\$ 744	744
--						
--						
--					(228)	
Other comprehensive loss net of tax, unrealized (loss) arising during the period (net of tax, \$117)						
Reclassification adjustment (net of tax, \$6)					(11)	
Other comprehensive loss (net of tax, \$123)	--	--		(239)	(239)	(239)
Total comprehensive income					\$ 505	
Acquisition of 118,000 shares of common stock *	(295)		(2,154)			(2,449)
Cash dividends declared	--	--	(278)	--		(278)
Balance, March 31, 2003	\$3,655	\$1,465	\$15,971	\$ 941		\$ 22,032

Notes to consolidated financial statements are an integral part of these statements

*Restated to give retroactive effect to two for one stock split declared on April 16, 2003 and payable as of May 30, 2003.

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

(In thousands of dollars)

(Unaudited)

Three Months Ended
March 31,20032002**CASH FLOWS FROM OPERATING ACTIVITIES:**

Net income \$ 744 \$ 702

Adjustments to reconcile net income to net cash

provided by operating activities:

Depreciation and amortization 138 98

Origination of loans available for sale (5,197) (3,347)

Proceeds from loans available for sale 6,243 3,384

Provision for loan losses 158 90

(Gain) on sale of securities available-for-sale (16) (70)

Accretion of security discounts (3) (3)

(Gain) on sale of loans (80) (37)

Amortization of security premiums, net 121 72

Changes in other assets and other liabilities:

Decrease in accrued interest receivable 157 48

(Increase) in other assets (121) (319)

Increase in accrued expenses and other liabilities 361 423

Net cash provided by operating activities \$ 2,505 \$ 1,041

CASH FLOWS FROM INVESTING ACTIVITIES:

Net (increase) decrease in loans (9,336) 1,347

Purchase of securities available-for-sale (5,567) (6,487)

Proceeds from sales of securities available-for-sale 1,081 2,097

Proceeds from calls, maturities, and principal payments on

securities available-for-sale 4,937 2,416

(Increase) in federal funds sold (8,098) (3,858)

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Purchase of bank premises and equipment	(582)	(347)
Net cash (used in) investing activities	\$ (17,565)	\$ (4,832)

CASH FLOWS FROM FINANCING ACTIVITIES:

Net increase in demand and savings deposits	\$ 7,329	\$ 5,576
Net increase (decrease) in time deposits	3,441	(1,144)
Net (decrease) in long-term debt	(12)	(2,065)
Proceeds from issuance of trust preferred capital notes	3,000	--
Cash dividends paid	(278)	(269)
Acquisition of common stock	(2,449)	--
Net cash provided by financing activities	\$ 11,031	\$ 2,098

Net (decrease) in cash and cash equivalents	(4,029)	(1,693)
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CASH AND CASH EQUIVALENTS -- BEGINNING OF PERIOD	14,920	6,754
CASH AND CASH EQUIVALENTS END OF PERIOD	\$ 10,891	\$ 5,061

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments for interest	\$ 1,813	\$ 1,945
Cash payments for income taxes	\$ 0	\$ 0

Notes to consolidated financial statements are an integral part of these statements.

FIRST NATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.

General

The accompanying unaudited consolidated financial statements of First National Corporation and its subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. 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 consisting of a normal and recurring nature considered necessary to present fairly the financial positions as of March 31, 2003 and December 31, 2002, the results of operations for the three months ended March 31, 2003 and 2002, and statements of cash flows and changes in stockholders' equity for the three months ended March 31, 2003 and 2002.

Operating results for the three month period ended March 31, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003.

2.

Investment Securities

Amortized cost and carrying amount (estimated market value) of securities available-for-sale are summarized as follows:

March 31, 2003

Gross	Gross	Estimated Market Value
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	Amortized	Unrealized	Unrealized	
	Cost	Gains	Losses	
		(In Thousands of Dollars)		
Obligations of U.S. government corporations and agencies	\$ 43,018	\$ 1,154	\$ --	\$ 44,172
Obligations of state/political subdivisions	6,952	234	--	7,186
Corporate securities	3	39	--	42
Other securities	1,743	0	--	1,743
	\$ 51,716	\$1,427	\$ --	\$ 53,143

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FIRST NATIONAL CORPORATION**Notes to Consolidated Financial Statements**

(Unaudited)

December 31, 2002

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
(In Thousands of Dollars)				
Obligations of U.S. government corporations and agencies	\$ 44,419	\$ 1,423	\$ --	\$ 45,902
Obligations of states/political subdivisions	6,002	235	--	6,237
Corporate securities	4	71	--	75
Other securities	2,271	--	--	2,271
	\$ 52,696	\$ 1,789	\$ --	\$ 54,485

3.**Loans**

Major classifications of loans are summarized as follows:

	March 31, 2003	December 31, 2002
(In thousand of dollars)		
Commercial	\$ 31,758	\$ 28,606
Real estate 1-4 family residential	54,322	58,705
Real estate secured by farmland	2,087	2,112
Real estate non-farm, non-residential	71,307	67,680

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Real estate construction	13,425	12,172
Consumer	48,981	43,327
Total loans	221,880	212,602
Less unearned income	0	0
Less allowance for loan losses	(2,261)	(2,162)
Loans, net	\$ 219,619	\$ 210,440

FIRST NATIONAL CORPORATION**Notes to Consolidated Financial Statements**

(Unaudited)

4. Capital Requirements

A comparison of the capital of the Company and its wholly-owned subsidiary, First Bank (the Bank), as of March 31, 2003 with the minimum regulatory guidelines is as follows:

	<u>Actual</u>	<u>Minimum Guidelines</u>	<u>Minimum to be Well-Capitalized</u>
Total Risk-Based Capital:			
Company	11.51%	8.00%	--
Bank	11.41%	8.00%	10.00%
Tier 1 Risk-Based Capital:			
Company	10.51%	4.00%	--
Bank	10.42%	4.00%	6.00%
Leverage Ratio:			
Company	8.11%	4.00%	--
Bank	8.02%	4.00%	5.00%

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

Forward-Looking Statements

This management's discussion and analysis and other portions of this report, contain forward-looking statements within the meaning of the Securities Exchange Act of 1934, as amended, including statements of goals, intentions, and expectations as to future trends, plans, events or results of Company operations and policies and regarding general economic conditions. In some cases, forward-looking statements can be identified by use of words such as may, will, anticipates, believes, expects, plans, estimates, potential, continue, should, and similar words or statements are based upon current and anticipated economic conditions, nationally and in the Company's market, interest rates and interest rate policy, competitive factors, and other conditions which by their nature, are not susceptible to accurate forecast, and are subject to significant uncertainty. Because of these uncertainties and the assumptions on which this discussion and the forward-looking statements are based, actual future operations and results in the future may differ materially from those indicated herein. Readers are cautioned against placing undue reliance on any such forward-looking statements. The Company does undertake to update any forward-looking statements to reflect occurrences or events that may not have been anticipated as of the date of such statements.

General

The following presents management's discussion and analysis of the consolidated financial condition and results of operations of First National Corporation and subsidiaries (the Company) as of the dates and for the periods indicated. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto, and other financial data appearing elsewhere in this report. The Company is the parent bank holding company for First Bank (the Bank), a Virginia state chartered bank that offers a full range of banking services through nine branch offices, principally to individuals and small to medium-size businesses in the Northern Shenandoah Valley area, including the counties of Shenandoah, Frederick and Warren.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our 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. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

Our allowance for loan losses has three basic components: the specific allowance, the formula allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance for loans identified for impairment testing. Impairment testing includes consideration of the borrower's overall financial condition, resources and payment record, support available from financial guarantors and the fair market value of collateral. These factors are combined to estimate the probability and severity of inherent losses. When impairment is identified, then a specific reserve is established based on the Company's calculation of the loss embedded in the individual loan. Large groups of smaller balance, homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment. The formula allowance is used for estimating the loss on internally risk rated loans exclusive of those identified for impairment testing. The loans meeting the criteria for special mention, substandard, doubtful and loss, as well as, impaired loans are segregated from performing loans within the portfolio. Each loan type is assigned an allowance factor based on management's estimate of the associated risk, complexity and size of the individual loans within the particular loan category. Classified loans are assigned a higher allowance factor than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements surrounding the borrower. Allowance factors grow with the worsening of the internal risk rating. The unallocated formula is used to estimate the loss of non-classified loans. These non-classified loans are segregated by loan type and allowance factors are assigned by management based primarily on loss history and economic conditions. The factors assigned differ by loan type. The unallocated allowance captures losses whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Results of Operations

Total assets increased \$11.8 million, or 4.0%, from \$295.9 million at December 31, 2002 to \$307.7 million at March 31, 2003 as total deposits grew \$10.8 million, or 4.4%, from \$243.0 million to \$253.8 million. The deposit growth and the \$1.3 million decline in securities funded an increase in total loans of \$9.2 million. Federal funds sold increased \$8.1 million.

The most deposit growth occurred in demand deposits, which increased \$4.4 million or 12.0%, from \$36.6 million at December 31, 2002 to \$41.0 million at March 31, 2003. Other deposit categories also increased, with savings and interest bearing demand deposits increasing \$2.9 million, or 2.8%, from \$107.1 million to \$110.1 million. Time deposits rose \$3.5 million or 3.5% during the period.

For the three months ended March 31, 2003 net income of \$744 thousand reflected an increase of 6.0% compared to \$702 thousand for the three months ended March 31, 2002 as net interest income increased \$310 thousand, or 14.0%, non-interest income rose \$286 thousand, or 55.1%, and non-interest expense was up \$445 thousand, or 27.5%. Provisions for loan losses for the three-month period increased over the prior year by \$68 thousand. Earnings per share of \$.49 were up \$0.04, or 8.9% from \$.45 for the comparable period in 2002. The Company's annualized return on average assets and return on average equity were 1.00% and 12.80%, respectively, for the current three month period compared to 1.13% and 12.93%, respectively, for the three months ended March 31, 2002.

Stockholders' equity decreased \$2.2 million from \$24.2 million at December 31, 2002 to \$22.0 million at March 31, 2003 on earnings of \$744 thousand, a decrease in accumulated other comprehensive income of \$239 thousand, while paying cash dividends of \$278 thousand. On February 26, 2003 the corporation repurchased 118,000 (as restated for a two-for-one common stock split declared on April 16, 2003 and payable on May 30, 2003) shares of outstanding common stock at a cost of \$2.4 million.

Net Interest Income

Net interest income increased \$310 thousand, or 14.0%, from \$2.2 million for the three months ended March 31, 2002 to \$2.5 million for the three-month period ended March 31, 2003. Although total average earning assets outstanding grew from \$237.4 million during the first three months of 2002 to \$279.7 million for the current three month period, the net interest spread remained approximately the same (3.19% in 2003 vs. 3.18% in 2002). The net interest margin on earning assets declined from 3.80% for the three months ended March 31, 2002 to 3.68% for the three month period ended March 31, 2003. As interest-earning assets repriced faster than interest-bearing liabilities during a declining interest rate environment, the Company's yield on interest-earning assets dropped 72 basis points from 6.94% for the three months ended March 31, 2002 to 6.22% for the three months ended March 31, 2003, while the average rate paid on interest-bearing liabilities decreased 73 basis points from 3.76% to 3.03%, as a result the net interest spread increased 1 basis point. The following table shows the average balance sheet, interest rate spread and net interest margin for the three months ended March 31, 2003 and 2002.

FIRST NATIONAL CORPORATION

AVERAGE BALANCES, INCOME AND EXPENSE, YIELDS AND RATES

Three Months Ended March 31,

	<u>2003</u>			<u>2002</u>		
	Average <u>Balance</u>	Annual <u>Income/ Expense</u>	Yield/ <u>Rate(3)</u>	Average <u>Balance</u>	Annual <u>Income/ Expense</u>	Yield/ <u>Rate(3)</u>
ASSETS						
Balances at correspondent banks - interest bearing	\$1,809,633	\$10,573	2.34%	\$1,025,597	\$7,440	2.90%
Securities:						
Taxable	46,262,773	504,212	4.36%	35,228,106	454,728	5.16%
Tax-exempt (1)	<u>6,058,036</u>	<u>108,489</u>	7.16%	<u>6,450,137</u>	<u>117,262</u>	7.27%
Total Securities	52,320,809	612,701	4.68%	41,678,243	571,990	5.49%
Loans: (2)						
Taxable	218,402,612	3,678,165	6.74%	185,111,597	3,485,377	7.53%
Tax-exempt (1)	<u>1,691,812</u>	<u>31,220</u>	7.38%	<u>1,037,662</u>	<u>20,382</u>	7.86%
Total Loans	220,094,424	3,709,385	6.74%	186,149,259	3,505,759	7.53%
Federal funds sold	<u>5,442,467</u>	<u>15,166</u>	1.11%	<u>8,539,289</u>	<u>35,717</u>	1.67%
Total earning assets	279,667,333	4,347,825	6.22%	237,392,388	4,120,906	6.94%
Less: allowance for loan losses	(2,230,454)			(2,005,187)		
Total non-earning assets	<u>19,953,616</u>			<u>13,415,036</u>		
Total Assets	<u>\$297,390,495</u>			<u>\$248,802,237</u>		
LIABILITIES AND STOCKHOLDERS EQUITY						
Interest bearing deposits:						
Checking	\$53,099,536	\$211,678	1.59%	\$14,069,586	\$32,128	0.91%
Money market savings	9,165,602	22,651	0.99%	7,392,783	30,831	1.67%
Regular savings	45,135,894	100,035	0.89%	60,032,646	292,222	1.95%
Time deposits:						
Less than \$100,000	66,842,443	704,062	4.21%	60,372,421	767,475	5.08%

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\$100,000 and more	<u>33,689,585</u>	<u>330,726</u>	3.93%	<u>28,331,658</u>	<u>311,617</u>	4.40%
Total interest bearing deposits	207,933,060	1,369,152	2.63%	170,199,094	1,434,273	3.37%
Federal funds purchased	0	0	--	0	0	--
Long-term debt	<u>26,766,589</u>	<u>406,416</u>	6.07%	<u>28,103,643</u>	<u>429,686</u>	6.12%
Total interest bearing liabilities	234,699,649	1,775,568	3.03%	198,302,737	1,863,959	3.76%
Non-interest bearing liabilities:						
Demand deposits	37,148,957			26,813,460		
Other liabilities	<u>2,286,435</u>			<u>1,973,358</u>		
Total liabilities	274,135,041			227,089,555		
Stockholders' equity	<u>23,255,454</u>			<u>21,712,682</u>		
Total liabilities and stockholders' equity	<u>\$297,390,495</u>			<u>\$248,802,237</u>		
Net interest income		<u>\$2,572,257</u>			<u>\$2,256,947</u>	