

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 12, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2011

or

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

For the transition period from            to

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

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

**112 West King Street, Strasburg, Virginia**  
(Address of principal executive offices)

**22657**  
(Zip Code)

**(540) 465-9121**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of August 11, 2011, 2,955,649 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) June 30, 2011	December 31, 2010
<b>Assets</b>		
Cash and due from banks	\$ 8,431	\$ 5,048
Interest-bearing deposits in banks	21,098	10,949
Federal funds sold		7,500
Securities available for sale, at fair value	82,780	60,420
Restricted securities, at cost	2,859	3,153
Loans held for sale		271
Loans, net of allowance for loan losses, 2011, \$13,778, 2010, \$16,036	401,724	418,994
Other real estate owned, net of valuation allowance, 2011, \$3,072, 2010, \$3,341	5,696	3,961
Premises and equipment, net	19,804	20,302
Interest receivable	1,706	1,667
Other assets	11,151	12,364
<b>Total assets</b>	<b>\$ 555,249</b>	<b>\$ 544,629</b>

**Liabilities and Shareholders Equity****Liabilities**

Deposits:		
Noninterest-bearing demand deposits	\$ 82,727	\$ 78,964
Savings and interest-bearing demand deposits	189,270	178,685
Time deposits	204,497	205,851
<b>Total deposits</b>	<b>\$ 476,494</b>	<b>\$ 463,500</b>
Other borrowings	18,111	20,122
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued expenses and other liabilities	2,768	3,230
Commitments and contingencies		
<b>Total liabilities</b>	<b>\$ 506,652</b>	<b>\$ 496,131</b>

**Shareholders Equity**

Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,194	\$ 14,127
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2011, 2,955,649 shares, 2010, 2,948,901 shares	3,695	3,686

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Surplus	1,644	1,582
Retained earnings	27,991	28,969
Accumulated other comprehensive income, net	1,073	134
Total shareholders' equity	\$ 48,597	\$ 48,498
Total liabilities and shareholders' equity	\$ 555,249	\$ 544,629

*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2011 and 2010

*(in thousands, except per share data)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 5,818	\$ 6,229
Interest on federal funds sold	4	
Interest on deposits in banks	5	2
Interest and dividends on securities available for sale:		
Taxable interest	572	432
Tax-exempt interest	121	142
Dividends	17	16
<b>Total interest and dividend income</b>	<b>\$ 6,537</b>	<b>\$ 6,821</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 1,303	\$ 1,501
Interest on federal funds purchased		6
Interest on company obligated mandatorily redeemable capital securities	109	109
Interest on other borrowings	42	103
<b>Total interest expense</b>	<b>\$ 1,454</b>	<b>\$ 1,719</b>
Net interest income	\$ 5,083	\$ 5,102
Provision for loan losses	3,550	1,000
Net interest income after provision for loan losses	\$ 1,533	\$ 4,102
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 535	\$ 682
ATM and check card fees	410	366
Trust and investment advisory fees	384	294
Fees for other customer services	74	91
Gains on sale of loans	22	25
Gains on sale of securities available for sale, net	41	
Other operating income	19	31
<b>Total noninterest income</b>	<b>\$ 1,485</b>	<b>\$ 1,489</b>

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**Noninterest Expense**

Salaries and employee benefits	\$ 2,280	\$ 2,290
Occupancy	331	351
Equipment	323	343
Marketing	100	128
Stationery and supplies	87	85
Legal and professional fees	269	194
ATM and check card fees	159	209
FDIC assessment	217	184
Bank franchise tax	104	109
Provision for other real estate owned	46	40
Other real estate owned expense	66	115
Net losses on sale of other real estate owned	8	
Telecommunications expense	86	70
Other operating expense	440	407
<b>Total noninterest expense</b>	<b>\$ 4,516</b>	<b>\$ 4,525</b>
Income (loss) before income taxes	\$ (1,498)	\$ 1,066
Income tax provision (benefit)	(553)	313
<b>Net income (loss)</b>	<b>\$ (945)</b>	<b>\$ 753</b>
Effective dividend on preferred stock	223	221
<b>Net income (loss) available to common shareholders</b>	<b>\$ (1,168)</b>	<b>\$ 532</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ (0.40)</b>	<b>\$ 0.18</b>

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2011 and 2010

*(in thousands, except per share data)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 11,651	\$ 12,489
Interest on federal funds sold	11	
Interest on deposits in banks	12	4
Interest and dividends on securities available for sale:		
Taxable interest	1,023	900
Tax-exempt interest	244	287
Dividends	34	28
<b>Total interest and dividend income</b>	<b>\$ 12,975</b>	<b>\$ 13,708</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 2,606	\$ 3,177
Interest on federal funds purchased		11
Interest on company obligated mandatorily redeemable capital securities	218	217
Interest on other borrowings	133	252
<b>Total interest expense</b>	<b>\$ 2,957</b>	<b>\$ 3,657</b>
Net interest income	\$ 10,018	\$ 10,051
Provision for loan losses	3,820	1,411
Net interest income after provision for loan losses	\$ 6,198	\$ 8,640
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,036	\$ 1,291
ATM and check card fees	781	680
Trust and investment advisory fees	726	604
Fees for other customer services	147	164
Gains on sale of loans	69	65
Gains on sale of securities available for sale, net	41	2
Other operating income	25	56
<b>Total noninterest income</b>	<b>\$ 2,825</b>	<b>\$ 2,862</b>



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**Noninterest Expense**

Salaries and employee benefits	\$ 4,568	\$ 4,517
Occupancy	672	695
Equipment	648	691
Marketing	205	252
Stationery and supplies	166	182
Legal and professional fees	470	420
ATM and check card fees	330	386
FDIC assessment	407	371
Bank franchise tax	209	209
Provision for other real estate owned	176	40
Other real estate owned expense	192	181
Net losses on sale of other real estate owned	8	52
Telecommunications expense	176	134
Other operating expense	844	844
<b>Total noninterest expense</b>	<b>\$ 9,071</b>	<b>\$ 8,974</b>
Income (loss) before income taxes	\$ (48)	\$ 2,528
Income tax provision (benefit)	(106)	760
<b>Net income</b>	<b>\$ 58</b>	<b>\$ 1,768</b>
Effective dividend on preferred stock	446	443
<b>Net income (loss) available to common shareholders</b>	<b>\$ (388)</b>	<b>\$ 1,325</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ (0.13)</b>	<b>\$ 0.45</b>

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2011 and 2010

*(in thousands)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 58	\$ 1,768
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	592	623
Origination of loans held for sale	(4,001)	(4,626)
Proceeds from sale of loans held for sale	4,341	4,901
Gains on sale of loans held for sale	(69)	(65)
Provision for loan losses	3,820	1,411
Provision for other real estate owned	176	40
Gains on sale of securities available for sale, net	(41)	(2)
Net losses on sale of other real estate owned	8	52
Accretion of security discounts	(29)	(21)
Amortization of security premiums	234	185
Shares acquired by leveraged ESOP		42
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(39)	13
(Increase) decrease in other assets	730	(310)
Decrease in accrued expenses and other liabilities	(562)	(1,527)
<b>Net cash provided by operating activities</b>	<b>\$ 5,218</b>	<b>\$ 2,484</b>
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities, calls, and principal payments of securities available for sale	\$ 9,921	\$ 5,615
Purchase of securities available for sale	(31,023)	
Proceeds from sales of restricted securities	294	
Decrease in federal funds sold	7,500	
Purchase of premises and equipment	(94)	(125)
Proceeds from sale of other real estate owned	384	1,779
Net (increase) decrease in loans	11,247	(3,007)
<b>Net cash provided by (used in) investing activities</b>	<b>\$ (1,771)</b>	<b>\$ 4,262</b>
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 14,348	\$ 12,422
Net decrease in time deposits	(1,354)	(34,193)
Proceeds from other borrowings	18,001	23,601
Principal payments on other borrowings	(20,012)	(23,654)

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Cash dividends paid on common stock	(519)	(715)
Cash dividends paid on preferred stock	(379)	(379)
Increase in federal funds purchased		13,304
Shares issued to leveraged ESOP		(26)
<b>Net cash provided by (used in) financing activities</b>	<b>\$ 10,085</b>	<b>\$ (9,640)</b>
Increase (decrease) in cash and cash equivalents	\$ 13,532	\$ (2,894)
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 15,997	\$ 14,977
Ending	\$ 29,529	\$ 12,083

*See Notes to Consolidated Financial Statements*

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

(Continued)

Six months ended June 30, 2011 and 2010

*(in thousands)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 2,962	\$ 3,836
Income taxes	\$	\$ 2,541
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gain on securities available for sale	\$ 1,422	\$ 405
Transfer from loans to other real estate owned	\$ 2,815	\$ 2,865
Loan originated from sale of other real estate owned	\$ 640	\$
Issuance of common stock, dividend reinvestment plan	\$ 71	\$ 107

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2011 and 2010

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

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
<b>Balance, December 31, 2009</b>	\$ 13,998	\$ 3,664	\$ 1,418	\$ 35,104	\$ (42)	\$ 665		\$ 54,807
Comprehensive income:								
Net income				1,768			\$ 1,768	1,768
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, \$139)							268	
Reclassification adjustment (net of tax, \$1)							(1)	
Other comprehensive income (net of tax, \$138)						267	\$ 267	267
Total comprehensive income							\$ 2,035	
Shares acquired by leveraged ESOP			(26)		42			16
Cash dividends on common stock (\$0.28 per share)				(822)				(822)
Issuance of 9,055 shares common stock, dividend reinvestment plan		12	95					107
Cash dividends on preferred stock				(379)				(379)
Accretion on preferred stock discount	64			(64)				
<b>Balance, June 30, 2010</b>	\$ 14,062	\$ 3,676	\$ 1,487	\$ 35,607	\$	\$ 932		\$ 55,764

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
<b>Balance, December 31, 2010</b>	\$ 14,127	\$ 3,686	\$ 1,582	\$ 28,969	\$	\$ 134		\$ 48,498

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Comprehensive income:						
Net income				58		\$ 58 58
Other comprehensive income, net of tax:						
Unrealized holding gains arising during the period (net of tax, \$497)						966
Reclassification adjustment (net of tax, \$14)						(27)
Other comprehensive income (net of tax, \$483)					939	939 939
Total comprehensive income						\$ 997
Cash dividends on common stock (\$0.20 per share)						
				(590)		(590)
Issuance of 6,748 shares common stock, dividend reinvestment plan	9	62				71
Cash dividends on preferred stock				(379)		(379)
Accretion on preferred stock discount	67			(67)		
<b>Balance, June 30, 2011</b>	\$ 14,194	\$ 3,695	\$ 1,644	\$ 27,991	\$	\$ 1,073 \$ 48,597

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2011 and December 31, 2010, the results of operations for the three and six months ended June 30, 2011 and 2010 and cash flows and changes in shareholders' equity for the six months ended June 30, 2011 and 2010. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2010. Operating results for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at June 30, 2011 and December 31, 2010 were as follows:

	<i>(in thousands)</i>			
	June 30, 2011			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 66,976	\$ 2,303	\$ (3)	\$ 69,276
Obligations of states and political subdivisions	12,879	477	(29)	13,327
Corporate equity securities	23	154		177
	\$ 79,878	\$ 2,934	\$ (32)	\$ 82,780

	<i>(in thousands)</i>			
	December 31, 2010			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 45,627	\$ 1,508	\$ (211)	\$ 46,924
Obligations of states and political subdivisions	13,290	225	(214)	13,301
Corporate equity securities	23	172		195
	\$ 58,940	\$ 1,905	\$ (425)	\$ 60,420

At June 30, 2011 and December 31, 2010, investments in an unrealized loss position that were temporarily impaired were as follows:

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	<i>(in thousands)</i>					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 1,997	\$ (3)	\$	\$	\$ 1,997	\$ (3)
Obligations of states and political subdivisions			459	(29)	459	(29)
	\$ 1,997	\$ (3)	\$ 459	\$ (29)	\$ 2,456	\$ (32)



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

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

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

At June 30, 2011, there was one U.S. agency and mortgage-backed security and one obligation of state and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.0 years at June 30, 2011.

The Company's investment in Federal Home Loan Bank (FHLB) stock totaled \$2.0 million at June 30, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at June 30, 2011, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.

**Note 3. Loans**

Loans at June 30, 2011 and December 31, 2010 are summarized as follows:

	<i>(in thousands)</i>	
	June 30, 2011	December 31, 2010
Real estate loans:		
Construction	\$ 50,741	\$ 52,591
Secured by 1-4 family residential	120,575	121,506
Other real estate loans	195,766	207,371
Commercial and industrial loans	35,513	40,683
Consumer loans	12,907	12,879

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Total loans	\$ 415,502	\$ 435,030
Allowance for loan losses	13,778	16,036
Loans, net	\$ 401,724	\$ 418,994

Consumer loans included \$279 thousand and \$231 thousand of demand deposit overdrafts at June 30, 2011 and December 31, 2010, respectively.

The Company has a credit concentration of loans secured by real estate. These loans totaled \$367.1 million, or 88% of total loans, and \$381.5 million, or 88% of total loans, at June 30, 2011 and December 31, 2010, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be impacted by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$42.3 million at June 30, 2011, representing 87% of total equity and 10% of total loans. At December 31, 2010, this concentration totaled \$41.6 million representing 86% of total equity and 10% of total loans. These loans are included in other real estate loans in the above table. The Company charged down \$1.5 million related to this concentration of credit risk during the six month period ended June 30, 2011 and \$147 thousand related to these loans during the year ended December 31, 2010.

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**Notes to Consolidated Financial Statements**

*(unaudited)*

The following table provides a summary of loan classes and an aging of past due loans as of June 30, 2011 and December 31, 2010:

	June 30, 2011 <i>(in thousands)</i>							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	Current	Total Loans	Nonaccrual loans	
Real estate loans:								
Construction	\$ 916	\$ 539	\$ 3,540	\$ 4,995	\$ 45,746	\$ 50,741	\$ 3,527	\$ 369
1-4 family residential								