

FIRST NATIONAL CORP /VA/  
Form 10-Q  
May 13, 2013  
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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 March 31, 2013

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

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(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 May 10, 2013, 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)	
	March 31, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 7,678	\$ 7,266
Interest-bearing deposits in banks	31,859	23,762
Securities available for sale, at fair value	89,089	89,456
Restricted securities, at cost	1,805	1,974
Loans held for sale		503
Loans, net of allowance for loan losses, 2013, \$12,756; 2012, \$13,075	369,583	370,519
Other real estate owned, net of valuation allowance, 2013, \$2,220; 2012, \$2,174	5,173	5,590
Premises and equipment, net	18,130	18,589
Accrued interest receivable	1,430	1,459
Bank owned life insurance	9,077	9,014
Other assets	3,705	4,565
<b>Total assets</b>	<b>\$ 537,529</b>	<b>\$ 532,697</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 90,789	\$ 85,118
Savings and interest-bearing demand deposits	224,150	221,601
Time deposits	155,041	160,198
Total deposits	\$ 469,980	\$ 466,917
Other borrowings	6,070	6,076
Trust preferred capital notes	9,279	9,279
Accrued interest and other liabilities	6,649	5,536
Total liabilities	\$ 491,978	\$ 487,808
<b>Shareholders Equity</b>		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,446	\$ 14,409
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2013 and 2012, 4,901,464 shares	6,127	6,127
Surplus	6,813	6,813
Retained earnings	19,156	18,399

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Accumulated other comprehensive loss, net	(991)	(859)
Total shareholders' equity	\$ 45,551	\$ 44,889
Total liabilities and shareholders' equity	\$ 537,529	\$ 532,697

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2013 and 2012

*(in thousands, except per share data)*

	(unaudited) March 31, 2013	(unaudited) March 31, 2012
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 4,933	\$ 5,547
Interest on federal funds sold		3
Interest on deposits in banks	10	3
Interest and dividends on securities available for sale:		
Taxable interest	372	535
Tax-exempt interest	73	102
Dividends	19	18
<b>Total interest and dividend income</b>	<b>\$ 5,407</b>	<b>\$ 6,208</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 706	\$ 986
Interest on trust preferred capital notes	56	62
Interest on other borrowings	29	80
<b>Total interest expense</b>	<b>\$ 791</b>	<b>\$ 1,128</b>
<b>Net interest income</b>	<b>\$ 4,616</b>	<b>\$ 5,080</b>
Provision for (recovery of) loan losses	(250)	2,000
<b>Net interest income after provision for (recovery of) loan losses</b>	<b>\$ 4,866</b>	<b>\$ 3,080</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 459	\$ 502
ATM and check card fees	333	372
Trust and investment advisory fees	452	346
Fees for other customer services	88	98
Gains on sale of loans	59	43
Net gains on sale of securities available for sale (includes net gains of \$0 and \$1,117 for the three months ended March 31, 2013 and 2012, respectively, related to accumulated other comprehensive income reclassifications for previously unrealized net gains on available-for-sale securities)		1,117
Gains on sale of premises and equipment	3	
Other operating income	107	36
<b>Total noninterest income</b>	<b>\$ 1,501</b>	<b>\$ 2,514</b>

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**Noninterest Expense**

Salaries and employee benefits	\$ 2,634	\$ 2,369
Occupancy	378	326
Equipment	299	306
Marketing	110	78
Stationery and supplies	75	81
Legal and professional fees	179	250
ATM and check card fees	158	156
FDIC assessment	341	178
Bank franchise tax	68	76
Provision for other real estate owned	174	401
Other real estate owned expense	49	253
Net (gains) losses on sale of other real estate owned	(116)	(90)
Telecommunications expense	62	61
Data processing	83	90
Loss on land lease termination	209	
Other operating expense	410	369
<b>Total noninterest expense</b>	<b>\$ 5,113</b>	<b>\$ 4,904</b>

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

(Continued)

Three months ended March 31, 2013 and 2012

*(in thousands, except per share data)*

	(unaudited) March 31, 2013	(unaudited) March 31, 2012
Income before income taxes	\$ 1,254	\$ 690
Income tax expense	271	215
<b>Net income</b>	<b>\$ 983</b>	<b>\$ 475</b>
Effective dividend on preferred stock	226	225
<b>Net income available to common shareholders</b>	<b>\$ 757</b>	<b>\$ 250</b>
<b>Earnings per common share, basic and diluted</b>	<b>\$ 0.15</b>	<b>\$ 0.08</b>

*See Notes to Consolidated Financial Statements*



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

Three months ended March 31, 2013 and 2012

*(in thousands, except per share data)*

	(unaudited) March 31, 2013	(unaudited) March 31, 2012
Net income	\$ 983	\$ 475
Other comprehensive loss:		
Unrealized loss on available for sale securities (net of tax, \$0 and \$29)	(132)	(121)
Reclassification adjustment (net of tax, \$0 and \$0)		(1,117)
Other comprehensive loss (net of tax, \$0 and \$29)	(132)	(1,238)
Total comprehensive income (loss)	\$ 851	\$ (763)

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2013 and 2012

*(in thousands)*

	(unaudited) March 31, 2013	(unaudited) March 31, 2012
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 983	\$ 475
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	252	283
Origination of loans held for sale	(1,799)	(1,692)
Proceeds from sale of loans held for sale	2,361	1,679
Gains on sale of loans held for sale	(59)	(43)
Provision for (recovery of) loan losses	(250)	2,000
Provision for other real estate owned	174	401
Net gains on sale of securities available for sale		(1,117)
Net gains on sale of other real estate owned	(116)	(90)
Gains on sale of premises and equipment	(3)	
Income from bank owned life insurance	(63)	
Accretion of discounts and amortization of premiums on securities, net	278	171
Changes in assets and liabilities:		
Decrease in interest receivable	29	97
(Increase) decrease in other assets	470	(463)
Increase (decrease) in other liabilities	1,113	(256)
<b>Net cash provided by operating activities</b>	<b>\$ 3,370</b>	<b>\$ 1,445</b>
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$ 1,850	\$ 24,217
Proceeds from maturities, calls, and principal payments of securities available for sale	7,999	7,726
Purchase of securities available for sale	(9,892)	(25,226)
Proceeds from redemption of restricted securities	169	
Purchase of premises and equipment	(17)	(131)
Proceeds from sale of premises and equipment	3	
Proceeds from sale of other real estate owned	1,038	2,423
Net (increase) decrease in loans	1,121	(1,176)
<b>Net cash provided by investing activities</b>	<b>\$ 2,271</b>	<b>\$ 7,833</b>
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 8,220	\$ 9,817
Net decrease in time deposits	(5,157)	(14,394)
Principal payments on other borrowings	(6)	(5,006)
Cash dividends paid on preferred stock	(189)	(189)

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Net cash provided by (used in) financing activities	\$ 2,868	\$ (9,772)
Increase (decrease) in cash and cash equivalents	\$ 8,509	\$ (494)
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 31,028	\$ 29,524
Ending	\$ 39,537	\$ 29,030

*See Notes to Consolidated Financial Statements*

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

(Continued)

Three months ended March 31, 2013 and 2012

*(in thousands)*

	(unaudited) March 31, 2013	(unaudited) March 31, 2012
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 813	\$ 1,154
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized loss on securities available for sale	\$ (132)	\$ (1,267)
Transfer from loans to other real estate owned	\$ 65	\$ 1,922
Transfer from premises and equipment to other real estate owned	\$ 224	\$

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2013 and 2012

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

	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				475		475
Other comprehensive loss					(1,238)	(1,238)
Cash dividends on preferred stock				(189)		(189)
Accretion on preferred stock discount	36			(36)		
<b>Balance, March 31, 2012</b>	\$ 14,299	\$ 3,695	\$ 1,644	\$ 16,753	\$ (247)	\$ 36,144

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2012</b>	\$ 14,409	\$ 6,127	\$ 6,813	\$ 18,399	\$ (859)	\$ 44,889
Net income				983		983
Other comprehensive loss					(132)	(132)
Cash dividends on preferred stock				(189)		(189)
Accretion on preferred stock discount	37			(37)		
<b>Balance, March 31, 2013</b>	\$ 14,446	\$ 6,127	\$ 6,813	\$ 19,156	\$ (991)	\$ 45,551

*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 March 31, 2013 and December 31, 2012, the results of operations and comprehensive income (loss) for the three months ended March 31, 2013 and 2012 and the cash flows and changes in shareholders' equity for the three months ended March 31, 2013 and 2012. 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, 2012. Operating results for the three month period ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

**Recent Accounting Pronouncements**

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

**Table of Contents****FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***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 March 31, 2013 and December 31, 2012 were as follows:

	<i>(in thousands)</i>			
	March 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 70,115	\$ 1,255	\$ (255)	\$ 71,115
Obligations of states and political subdivisions	17,335	744	(108)	17,971
Corporate equity securities	1	2		3
	\$ 87,451	\$ 2,001	\$ (363)	\$ 89,089

	<i>(in thousands)</i>			
	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 72,129	\$ 1,325	\$ (236)	\$ 73,218
Obligations of states and political subdivisions	15,556	762	(83)	16,235
Corporate equity securities	1	2		3
	\$ 87,686	\$ 2,089	\$ (319)	\$ 89,456

At March 31, 2013 and December 31, 2012, investments in an unrealized loss position that were temporarily impaired were as follows:

<i>(in thousands)</i>					
March 31, 2013					
Less than 12 months		12 months or more		Total	
Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)

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U.S. agency and mortgage-backed securities	\$ 26,066	\$ (255)	\$	\$	\$ 26,066	\$ (255)
Obligations of states and political subdivisions	6,405	(108)			6,405	(108)
	\$ 32,471	\$ (363)	\$	\$	\$ 32,471	\$ (363)

(in thousands)

	Less than 12 months		December 31, 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	\$ 19,612	\$ (236)	\$	\$	\$ 19,612	\$ (236)
Obligations of states and political subdivisions	4,287	(83)			4,287	(83)
	\$ 23,899	\$ (319)	\$	\$	\$ 23,899	\$ (319)



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

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 March 31, 2013, there were sixteen U.S. agency and mortgage-backed securities and twelve 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 4.3 years at March 31, 2013. At December 31, 2012, there were twelve U.S. agency and mortgage-backed securities and nine obligations of states and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio was considered investment grade at December 31, 2012. The weighted-average re-pricing term of the portfolio was 3.6 years at December 31, 2012.

Federal Home Loan Bank, Federal Reserve Bank and Community Bankers Bank stock are generally viewed as long-term investments and as restricted securities, which are carried at cost, because there is a minimal market for the stock. Therefore, when evaluating restricted securities for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider these investments to be other-than-temporarily impaired at March 31, 2013, and no impairment has been recognized. Restricted securities are not part of the available for sale securities portfolio.

The composition of restricted securities at March 31, 2013 and December 31, 2012 was as follows:

	<i>(in thousands)</i>	
	March 31, 2013	December 31, 2012
Federal Home Loan Bank stock	\$ 909	\$ 1,078
Federal Reserve Bank stock	846	846
Community Bankers Bank stock	50	50
	\$ 1,805	\$ 1,974

**Note 3. Loans**

Loans at March 31, 2013 and December 31, 2012 are summarized as follows:

	<i>(in thousands)</i>	
	March 31, 2013	December 31, 2012

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Real estate loans:		
Construction and land development	\$ 45,783	\$ 43,524
Secured by 1-4 family residential	143,765	134,964
Other real estate loans	162,742	174,220
Commercial and industrial loans	22,743	23,071
Consumer and other loans	7,306	7,815
<b>Total loans</b>	<b>\$ 382,339</b>	<b>\$ 383,594</b>
Allowance for loan losses	12,756	13,075
<b>Loans, net</b>	<b>\$ 369,583</b>	<b>\$ 370,519</b>

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

Consumer and other loans included \$71 thousand and \$153 thousand of demand deposit overdrafts at March 31, 2013 and December 31, 2012, respectively.

Risk characteristics of each loan portfolio class that were considered by the Company include:

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.

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 following table provides a summary of loan classes and an aging of past due loans as of March 31, 2013 and December 31, 2012:

	March 31, 2013 <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	Non-accrual Loans	
<b>Real estate loans:</b>								
Construction and land development	\$ 4,216	\$ 199	\$ 557	\$ 4,972	\$ 40,811	\$ 45,783	\$ 4,988	\$
1-4 family residential	910	107	71	1,088	142,677	143,765	1,576	
Other real estate loans	2,376	1,886	1,395	5,657	157,085	162,742	3,132	
Commercial and industrial	272	131		403	22,340	22,743	12	
Consumer and other loans	32		7	39	7,267	7,306	7	

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Total	\$ 7,806	\$ 2,323	\$ 2,030	\$ 12,159	\$ 370,180	\$ 382,339	\$ 9,715	\$
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	December 31, 2012 <i>(in thousands)</i>							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
<b>Real estate loans:</b>								
Construction and land development	\$ 77	\$ 701	\$ 89	\$ 867	\$ 42,657	\$ 43,524	\$ 646	\$
1-4 family residential	2,741		476	3,217	131,747	134,964	968	129
Other real estate loans	1,347	686	1,476	3,509	170,711	174,220	6,752	
Commercial and industrial	428	408	99	935	22,136	23,071	14	99
Consumer and other loans	43	5	8	56	7,759	7,815	13	
<b>Total</b>	<b>\$ 4,636</b>	<b>\$ 1,800</b>	<b>\$ 2,148</b>	<b>\$ 8,584</b>	<b>\$ 375,010</b>	<b>\$ 383,594</b>	<b>\$ 8,393</b>	<b>\$ 228</b>

**Credit Quality Indicators**

As part of the ongoing 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 credit issues arise. In addition, a certain amount of loans are reviewed each year through the Company's internal and external loan review process. A description of the general characteristics of the loan grading categories is as follows:

**Pass** Loans classified as pass exhibit acceptable operating trends, balance sheet trends, and liquidity. Sufficient cash flow exists to service the loan. All obligations have been paid by the borrower in an as agreed manner.

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

**Substandard** Loans classified as substandard are inadequately protected by the current net worth and payment capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation 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 weaknesses 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.

**Loss** Loans classified as loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted.



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

The following tables provide an analysis of the credit risk profile of each loan class as of March 31, 2013 and December 31, 2012:

	March 31, 2013 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 24,600	\$ 5,184	\$ 15,999	\$	\$ 45,783
Secured by 1-4 family residential	129,159	6,421	8,185		143,765
Other real estate loans	125,182	14,170	23,390		162,742
Commercial and industrial	18,673	839	3,231		22,743
Consumer and other loans	7,235	71			7,306
<b>Total</b>	<b>\$ 304,849</b>	<b>\$ 26,685</b>	<b>\$ 50,805</b>	<b>\$</b>	<b>\$ 382,339</b>

	December 31, 2012 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 22,384	\$ 5,176	\$ 15,964	\$	\$ 43,524
Secured by 1-4 family residential	120,692	6,055	8,217		134,964
Other real estate loans	134,701	14,513	25,006		174,220
Commercial and industrial	18,831	798	3,442		23,071
Consumer and other loans	7,743	72			7,815
<b>Total</b>	<b>\$ 304,351</b>	<b>\$ 26,614</b>	<b>\$ 52,629</b>	<b>\$</b>	<b>\$ 383,594</b>

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the three months ended March 31, 2013 and 2012 and for the year ended December 31, 2012 were as follows:

	(in thousands)		
	March 31, 2013	December 31, 2012	March 31, 2012
Balance at beginning of year	\$ 13,075	\$ 12,937	\$ 12,937

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Provision charged to (recovery from) operating expense	(250)	3,555	2,000
Loan recoveries	209	376	125
Loan charge-offs	(278)	(3,793)	(1,426)
Balance at end of period	\$ 12,756	\$ 13,075	\$ 13,636



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The following tables present, as of March 31, 2013, December 31, 2012 and March 31, 2012, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	March 31, 2013 (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, 2012	\$ 2,481	\$ 3,712	\$ 6,163	\$ 608	\$ 111	\$ 13,075
Charge-offs		(149)	(82)		(47)	(278)
Recoveries		2	7	139	61	209
Provision for (recovery of) loan losses	(84)	134	(263)	(4)	(33)	(250)
Ending Balance, March 31, 2013	\$ 2,397	\$ 3,699	\$ 5,825	\$ 743	\$ 92	\$ 12,756
<b>Ending Balance:</b>						
Individually evaluated for impairment	604	156	903	261		1,924
Collectively evaluated for impairment	1,793	3,543	4,922	482	92	10,832
<b>Loans:</b>						
Ending Balance	45,783	143,765	162,742	22,743	7,306	382,339
Individually evaluated for impairment	6,098	2,959	7,654	2,509		19,220
Collectively evaluated for impairment	39,685	140,806	155,088	20,234	7,306	363,119

	December 31, 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	(431)	(761)	(2,154)	(261)	(186)	(3,793)
Recoveries	1	68	64	35	208	376
Provision for (recovery of) loan losses	68	639	3,061	(129)	(84)	3,555
Ending Balance, December 31, 2012	\$ 2,481	\$ 3,712	\$ 6,163	\$ 608	\$ 111	\$ 13,075

Ending Balance:

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Individually evaluated for impairment	567	306	930	35		1,838
Collectively evaluated for impairment	1,914	3,406	5,233	573	111	11,237

**Loans:**

Ending Balance	43,524	134,964	174,220	23,071	7,815	383,594
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Individually evaluated for impairment	2,516	3,776	10,528	160		16,980
Collectively evaluated for impairment	41,008	131,188	163,692	22,911	7,815	366,614

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	March 31, 2012 <i>(in thousands)</i>					
	Commercial and Industrial	Other Real Estate	Construction and Land Development	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2011	\$ 963	\$ 5,192	\$ 2,843	\$ 3,766	\$ 173	\$ 12,937
Charge-offs		(503)	(369)	(481)	(73)	(1,426)
Recoveries	5	52		2	66	125
Provision for loan losses	(170)	649	679	854	(12)	2,000
Ending Balance, March 31, 2012	\$ 798	\$ 5,390	\$ 3,153	\$ 4,141	\$ 154	\$ 13,636

**Ending Balance:**

Individually evaluated for impairment	134	574	1,062	1,041		2,811
Collectively evaluated for impairment	664	4,816	2,091	3,100	154	10,825

**Loans:**

Ending Balance	29,449	175,738	49,893	125,628	9,686	390,394
Individually evaluated for impairment	481	9,453	5,742	5,946		21,622
Collectively evaluated for impairment	28,968	166,285	44,151	119,682	9,686	368,772

Impaired loans and the related allowance at March 31, 2013 and December 31, 2012, were as follows:

	March 31, 2013 <i>(in thousands)</i>						
	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	\$ 6,441	\$ 4,988	\$ 1,110	\$ 6,098	\$ 604	\$ 4,244	\$ 16
Secured by 1-4 family	3,898	1,024	1,935	2,959	156	4,116	23
Other real estate loans	9,443	1,645	6,009	7,654	903	9,151	70
Commercial and industrial	2,510		2,509	2,509	261	185	27
Consumer and other loans							
Total	\$ 22,292	\$ 7,657	\$ 11,563	\$ 19,220	\$ 1,924	\$ 17,696	\$ 136

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