FIRST NATIONAL CORP /VA/
Form 10-Q
November 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 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)

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)	**(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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date 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 x 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	x

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

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 9, 2011, 2,955,649 shares of common stock, par value $1.25 per share, of the registrant were outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements
FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

(in thousands, except share and per share data)

	(unaudited) September 30, 2011	December 31, 2010
Assets		
Cash and due from banks	$ 6,409	$ 5,048
Interest-bearing deposits in banks	16,316	10,949
Federal funds sold		7,500
Securities available for sale, at fair value	85,460	60,420
Restricted securities, at cost	2,889	3,153
Loans held for sale		271
Loans, net of allowance for loan losses, 2011, $18,502, 2010, $16,036	390,706	418,994
Other real estate owned, net of valuation allowance, 2011, $3,999, 2010, $3,341	5,576	3,961
Premises and equipment, net	19,657	20,302
Interest receivable	1,660	1,667
Other assets	12,848	12,364
Total assets	$ 541,521	$ 544,629
Liabilities and Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 81,836	$ 78,964
Savings and interest-bearing demand deposits	190,388	178,685
Time deposits	185,798	205,851
Total deposits	$ 458,022	$ 463,500
Other borrowings	25,106	20,122
Trust preferred capital notes	9,279	9,279
Other liabilities	3,099	3,230
Total liabilities	$ 495,506	$ 496,131
Shareholders Equity		
Preferred stock, $1,000 liquidation preference; 14,595 shares issued and outstanding	$ 14,229	$ 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

Surplus		1,644		1,582
Retained earnings		24,859		28,969
Accumulated other comprehensive income, net		1,588		134
Total shareholders equity	$	46,015	$	48,498
Total liabilities and shareholders equity	$	541,521	$	544,629

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

Three months ended September 30, 2011 and 2010

(in thousands, except per share data)

	(unaudited) September 30, 2011	(unaudited) September 30, 2010
Interest and Dividend Income		
Interest and fees on loans	$ 5,666	$ 6,239
Interest on federal funds sold	2	1
Interest on deposits in banks	3	5
Interest and dividends on securities available for sale:		
Taxable interest	595	398
Tax-exempt interest	121	132
Dividends	16	15
Total interest and dividend income	$ 6,403	$ 6,790
Interest Expense		
Interest on deposits	$ 1,204	$ 1,397
Interest on federal funds purchased		1
Interest on trust preferred capital notes	109	112
Interest on other borrowings	42	104
Total interest expense	$ 1,355	$ 1,614
Net interest income	$ 5,048	$ 5,176
Provision for loan losses	5,575	1,200
Net interest income (loss) after provision for loan losses	$ (527)	$ 3,976
Noninterest Income		
Service charges on deposit accounts	$ 590	$ 668
ATM and check card fees	391	378
Trust and investment advisory fees	350	330
Fees for other customer services	84	75
Gains on sale of loans	25	76
Gains (losses) on sale of securities available for sale, net		(9)
Other operating income (loss)	33	(10)
Total noninterest income	$ 1,473	$ 1,508

Noninterest Expense		
Salaries and employee benefits	$ 2,299	$ 2,239
Occupancy	347	358
Equipment	325	344
Marketing	109	142
Stationery and supplies	88	110
Legal and professional fees	276	210
ATM and check card fees	162	219
FDIC assessment	181	177
Bank franchise tax	103	109
Provision for other real estate owned	927	111
Other real estate owned expense	133	30
Net (gains) losses on sale of other real estate owned	(36)	(29)
Telecommunications expense	63	72
Data processing	79	66
Other operating expense	332	348
Total noninterest expense	$ 5,388	$ 4,506
Income (loss) before income taxes	$ (4,442)	$ 978
Income tax provision (benefit)	(1,556)	284
Net income (loss)	$ (2,886)	$ 694
Effective dividend on preferred stock	224	221
Net income (loss) available to common shareholders	$ (3,110)	$ 473
Earnings (loss) per common share, basic and diluted	$ (1.05)	$ 0.16

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

Nine months ended September 30, 2011 and 2010

(in thousands, except per share data)

	(unaudited) September 30, 2011	(unaudited) September 30, 2010
Interest and Dividend Income		
Interest and fees on loans	$ 17,317	$ 18,728
Interest on federal funds sold	13	1
Interest on deposits in banks	15	9
Interest and dividends on securities available for sale:		
Taxable interest	1,618	1,298
Tax-exempt interest	365	419
Dividends	50	43
Total interest and dividend income	$ 19,378	$ 20,498
Interest Expense		
Interest on deposits	$ 3,810	$ 4,574
Interest on federal funds purchased		12
Interest on trust preferred capital notes	327	329
Interest on other borrowings	175	356
Total interest expense	$ 4,312	$ 5,271
Net interest income	$ 15,066	$ 15,227
Provision for loan losses	9,395	2,611
Net interest income after provision for loan losses	$ 5,671	$ 12,616
Noninterest Income		
Service charges on deposit accounts	$ 1,626	$ 1,959
ATM and check card fees	1,172	1,058
Trust and investment advisory fees	1,076	934
Fees for other customer services	231	239
Gains on sale of loans	94	141
Gains (losses) on sale of securities available for sale, net	41	(7)
Other operating income	58	46
Total noninterest income	$ 4,298	$ 4,370

Noninterest Expense				
Salaries and employee benefits	$	6,867	$	6,756
Occupancy		1,019		1,053
Equipment		973		1,035
Marketing		314		394
Stationery and supplies		254		292
Legal and professional fees		746		630
ATM and check card fees		492		605
FDIC assessment		588		548
Bank franchise tax		312		318
Provision for other real estate owned		1,103		151
Other real estate owned expense		325		211
Net (gains) losses on sale of other real estate owned		(28)		23
Telecommunications expense		239		206
Data processing		220		187
Other operating expense		1,035		1,071
Total noninterest expense	$	14,459	$	13,480
Income (loss) before income taxes	$	(4,490)	$	3,506
Income tax provision (benefit)		(1,662)		1,044
Net income (loss)	$	(2,828)	$	2,462
Effective dividend on preferred stock		670		664
Net income (loss) available to common shareholders	$	(3,498)	$	1,798
Earnings (loss) per common share, basic and diluted	$	(1.18)	$	0.61

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Nine months ended September 30, 2011 and 2010

(in thousands)

	(unaudited) September 30, 2011	(unaudited) September 30, 2010
Cash Flows from Operating Activities		
Net income (loss)	$ (2,828)	$ 2,462
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	896	933
Origination of loans held for sale	(6,277)	(10,745)
Proceeds from sale of loans held for sale	6,642	10,169
Gains on sale of loans held for sale	(94)	(141)
Provision for loan losses	9,395	2,611
Provision for other real estate owned	1,103	151
(Gains) losses on sale of securities available for sale, net	(41)	7
Net (gains) losses on sale of other real estate owned	(28)	23
Accretion of discounts and amortization of premiums on securities, net	339	243
Shares acquired by leveraged ESOP		42
Changes in assets and liabilities:		
Decrease in interest receivable	7	38
(Increase) decrease in other assets	(1,233)	43
Decrease in other liabilities	(231)	(1,764)
Net cash provided by operating activities	$ 7,650	$ 4,072
Cash Flows from Investing Activities		
Proceeds from sales of securities available for sale	$ 2,557	$ 1,509
Proceeds from maturities, calls, and principal payments of securities available for sale	11,075	8,103
Purchase of securities available for sale	(36,768)	(6,664)
Proceeds from sales of restricted securities	264	184
Decrease in federal funds sold	7,500	
Purchase of premises and equipment	(251)	(248)
Proceeds from sale of other real estate owned	784	2,353
Net decrease in loans	15,520	1,011
Net cash provided by investing activities	$ 681	$ 6,248
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$ 14,575	$ 17,192
Net decrease in time deposits	(20,053)	(27,955)
Proceeds from other borrowings	33,001	23,601
Principal payments on other borrowings	(28,017)	(23,659)

Cash dividends paid on common stock		(541)		(1,072)
Cash dividends paid on preferred stock		(568)		(568)
Shares issued to leveraged ESOP				(26)
Net cash used in financing activities	$	(1,603)	$	(12,487)
Increase (decrease) in cash and cash equivalents	$	6,728	$	(2,167)
Cash and Cash Equivalents				
Beginning	$	15,997	$	14,977
Ending	$	22,725	$	12,810

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Nine months ended September 30, 2011 and 2010

(in thousands)

	(unaudited) September 30, 2011	(unaudited) September 30, 2010
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 4,422	$ 5,459
Income taxes	$	$ 3,061
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gain on securities available for sale	$ 2,202	$ 537
Transfer from loans to other real estate owned	$ 3,373	$ 2,865
Loan originated from sale of other real estate owned	$ 640	$
Issuance of common stock, dividend reinvestment plan	$ 71	$ 161

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

Nine months ended September 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
Balance, December 31, 2009	$ 13,998	$ 3,664	$ 1,418	$ 35,104	$ (42)	$ 665		$ 54,807
Comprehensive income:								
Net income				2,462			$ 2,462	2,462
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, $181)							349	
Reclassification adjustment (net of tax, $2)							5	
Other comprehensive income (net of tax, $183)						354	$ 354	354
Total comprehensive income							$ 2,816	
Shares acquired by leveraged ESOP			(26)		42			16
Cash dividends on common stock ($0.42 per share)				(1,233)				(1,233)
Issuance of 13,323 shares common stock, dividend reinvestment plan		17	144					161
Cash dividends on preferred stock				(568)				(568)
Accretion on preferred stock discount	96			(96)				
Balance, September 30, 2010	$ 14,094	$ 3,681	$ 1,536	$ 35,669	$	$ 1,019		$ 55,999

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income (Loss)	Total
Balance, December 31, 2010	$ 14,127	$ 3,686	$ 1,582	$ 28,969	$	$ 134		$ 48,498
Comprehensive income (loss):								
Net loss				(2,828)			$ (2,828)	(2,828)
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, $762)							1,481	
Reclassification adjustment (net of tax, $14)							(27)	

Other comprehensive income (net of tax, $748)						1,454	1,454	1,454
Total comprehensive loss							$ (1,374)	
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)				
Balance, September 30, 2011	$ 14,229	$ 3,695	$ 1,644	$ 24,859	$	$ 1,588		$ 46,015

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, 2011 and December 31, 2010, the results of operations for the three and nine months ended September 30, 2011 and 2010 and cash flows and changes in shareholders equity for the nine months ended September 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 nine month periods ended September 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 September 30, 2011 and December 31, 2010 were as follows:

	0000000000	0000000000	0000000000	0000000000
	(in thousands) September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 68,880	$ 2,793	$	$ 71,673
Obligations of states and political subdivisions	12,875	803	(7)	13,671
Corporate equity securities	23	93		116
	$ 81,778	$ 3,689	$ (7)	$ 85,460

	0000000000	0000000000	0000000000	0000000000
	(in thousands) December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
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 September 30, 2011 and December 31, 2010, investments in an unrealized loss position that were temporarily impaired were as follows:

	000000		000000		000000		000000		000000		000000	
	(in thousands)											
	September 30, 2011											
	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	$		$		$		$		$		$	
Obligations of states and political subdivisions						480		(7)		480		(7)
	$		$		$	480	$	(7)	$	480	$	(7)

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Notes to Consolidated Financial Statements

(unaudited)

	000000	000000	000000	000000	000000	000000
			(in thousands)			
			December 31, 2010			
	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	$ 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 September 30, 2011, there was 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 3.2 years at September 30, 2011.

The Company s investment in Federal Home Loan Bank (FHLB) stock totaled $2.0 million at September 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 September 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 September 30, 2011 and December 31, 2010 are summarized as follows:

	(in thousands)	
	September 30, 2011	December 31, 2010
Real estate loans:		
Construction	$ 49,310	$ 52,591
Secured by 1-4 family residential	120,014	121,506
Other real estate loans	195,486	207,371
Commercial and industrial loans	32,649	40,683

Consumer and other loans	11,749	12,879
Total loans	$ 409,208	$ 435,030
Allowance for loan losses	18,502	16,036
Loans, net	$ 390,706	$ 418,994

Consumer loans included $165 thousand and $231 thousand of demand deposit overdrafts at September 30, 2011 and December 31, 2010, respectively.

The Company has a credit concentration of loans secured by real estate. These loans totaled $364.8 million, or 89% of total loans, and $381.5 million, or 88% of total loans, at September 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 $35.1 million at September 30, 2011, representing 76% of total equity and 9% 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 $2.0 million related to this concentration of credit risk during the nine month period ended September 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 September 30, 2011 and December 31, 2010:

	0000000	0000000	0000000	0000000	0000000	0000000	0000000	0000000
	September 30, 2011 *(in thousands)*							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	$ 3,998	$ 351	$ 4,156	$ 8,505	$ 40,805	$ 49,310	$ 4,146	$ 361
1-4 family residential	4,981	557	706	6,244	113,770	120,014	3,953	
Other real estate loans	7,787	1,813	1,012	10,612	184,874	195,486	12,558	
Commercial and industrial	203	112	312	627	32,022	32,649	2,040	312
Consumer and other	69	6	10	85	11,664	11,749	10	
Total	$ 17,038	$ 2,839	$ 6,196	$ 26,073	$ 383,135	$ 409,208	$ 22,707	$ 673

	0000000	0000000	0000000	0000000	0000000	0000000	0000000	0000000
	December 31, 2010 *(in thousands)*							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	$ 525	$	$ 3,665	$ 4,190	$ 48,401	$ 52,591	$ 5,780	$
1-4 family residential	2,642	178	315	3,135	118,371	121,506	628	315
Other real estate loans	10,225	3,475	751	14,451	192,920	207,371	4,407	283
Commercial and industrial	1,033	3		1,036	39,647	40,683		
Consumer	168	10	1	179	12,700	12,879	2	
Total	$ 14,593	$ 3,666	$ 4,732	$ 22,991	$ 412,039	$ 435,030	$ 10,817	$ 598

Credit Quality Indicators

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

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

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

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

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

Notes to Consolidated Financial Statements

(unaudited)

The following tables provide an analysis of the credit risk profile of each loan class as of September 30, 2011 and December 31, 2010:

	00000000	00000000	00000000	00000000	00000000
			September 30, 2011 *(in thousands)*		
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction	$ 21,796	$ 6,028	$ 19,149	$ 2,337	$ 49,310
Secured by 1-4 family residential	104,965	6,729	8,320		120,014
Other real estate loans	143,454	14,579	31,235	6,218	195,486
Commercial and industrial	27,460	1,101	4,088		32,649
Consumer	11,657	82	10		11,749
Total	$ 309,332	$ 28,519	$ 62,802	$ 8,555	$ 409,208

	00000000	00000000	00000000	00000000	00000000
			December 31, 2010 *(in thousands)*		
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction	$ 21,212	$ 5,237	$ 21,471	$ 4,671	$ 52,591
Secured by 1-4 family residential	106,722	4,435	10,349		121,506
Other real estate loans	143,874	17,915	43,443	2,139	207,371
Commercial and industrial	34,619	4,033	2,031		40,683
Consumer	12,864	13	1	1	12,879
Total	$ 319,291	$ 31,633	$ 77,295	$ 6,811	$ 435,030

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the nine months ended September 30, 2011 and 2010 and for the year ended December 31, 2010 were as follows:

(in thousands)

	September 30, 2011	December 31, 2010	September 30, 2010
Balance at beginning of year	$ 16,036	$ 7,106	$ 7,106
Provision charged to operating expense	9,395	11,731	2,611
Loan recoveries	208	261	197
Loan charge-offs	(7,137)	(3,062)	(1,320)
Balance at end of period	$ 18,502	$ 16,036	$ 8,594

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Notes to Consolidated Financial Statements

(unaudited)

The following tables present, as of September 30, 2011 and December 31, 2010, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	000000	000000	000000	000000	000000	000000
	September 30, 2011 *(in thousands)*					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2010	$ 858	$ 9,187	$ 4,050	$ 1,681	$ 260	$ 16,036
Charge-offs	(233)	(3,420)	(2,557)	(726)	(201)	(7,137)
Recoveries	1			4	203	208
Provision for loan losses	2,190	2,387	1,870	3,011	(63)	9,395
Ending Balance, September 30, 2011	$ 2,816	$ 8,154	$ 3,363	$ 3,970	$ 199	$ 18,502
Ending Balance:						
Individually evaluated for impairment	2,192	4,457	1,639	2,386		10,674
Collectively evaluated for impairment	624	3,697	1,724	1,584	199	7,828
Loans:						
Ending Balance	$ 32,649	$ 195,486	$ 49,310	$ 120,014	$ 11,749	$ 409,208
Individually evaluated for impairment	2,373	24,244	10,194	8,382		45,193
Collectively evaluated for impairment	30,276	171,242	39,116	111,632	11,749	364,015

	000000	000000	000000	000000	000000	000000
	December 31, 2010 *(in thousands)*					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
Allowance for loan losses:						
Ending Balance	$ 858	$ 9,187	$ 4,050	$ 1,681	$ 260	$ 16,036
Ending Balance:						
Individually evaluated for impairment	36	5,020	3,006	536		8,597
Collectively evaluated for impairment	822	4,167	1,044	1,145	260	7,439
Loans:						
Ending Balance	40,683	207,371	52,591	121,506	12,879	435,030
Ending Balance:						
Individually evaluated for impairment	48	28,426	9,709	5,682		43,865

Collectively evaluated for impairment	40,635	178,945	42,882	115,824	12,879	391,165

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Notes to Consolidated Financial Statements

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Impaired loans and the related allowance at September 30, 2011 and December 31, 2010, were as follows:

	0000000	0000000	0000000	0000000	0000000	0000000	0000000
				September 30, 2011 *(in thousands)*			
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	$ 12,163	$ 2,068	$ 8,126	$ 10,194	$ 1,639	$ 6,400	$ 293
Secured by 1-4 family	8,478	450	7,932	8,382	2,386	6,837	194
Other real estate loans	27,098	11,500	12,744	24,244	4,457	25,809	711
Commercial and industrial	2,373	10	2,363	2,373	2,192	94	77
Consumer and other loans							
Total	$ 50,112	$ 14,028	$ 31,165	$ 45,193	$ 10,674	$ 39,139	$ 1,275

	0000000	0000000	0000000	0000000	0000000	0000000	0000000
				December 31, 2010 *(in thousands)*			
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	$ 10,440	$ 1,217	$ 8,492	$ 9,709	$ 3,006	$ 2,920	$ 374
Secured by 1-4 family	5,701	595	5,087	5,682	536	795	222
Other real estate loans	29,480	7,904	20,522	28,426	5,020	18,432	1,345
Commercial and industrial	48		48	48	36	163	4
Consumer and other loans							
Total	$ 45,669	$ 9,716	$ 34,149	$ 43,865	$ 8,597	$ 22,310	$ 1,945

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

During the first quarter of 2011, the Bank adjusted its allowance for loan losses methodology by expanding the historical loss period that is applied to the general component of the allowance from one year to three years. The Company decreased the loss history to one year after significant deterioration in economic conditions in 2008. Since then, the Company has determined that a three-year loss history is more appropriate to reflect a reasonable loss inherent in the loan portfolio. For further information on the Company s allowance for loan losses

methodology, see the Allowance for Loan Losses section included in Part I, Item 2 of this Form 10-Q.

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As of September 30, 2011 loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled $13.2 million. At September 30, 2011, $6.2 million of the loans classified as TDRs were performing under the restructured terms and were not considered nonperforming assets. There were $14.4 million in TDRs at December 31, 2010. The following table provides further information regarding loans modified under TDRs during the three and nine month periods ended September 30, 2011:

	For the three months ended September 30, 2011 (dollars in thousands)			For the nine months ended September 30, 2011 (dollars in thousands)		
	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	1	$ 701	$ 357
Secured by 1-4 family				2	575	575
Other real estate loans				12	11,724	11,750
Commercial and industrial						
Consumer and other loans						
Total	1	$ 701	$ 357	15	$ 13,000	$ 12,682

As of September 30, 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.

Note 5. Other Borrowings

The Bank had unused lines of credit totaling $117.8 million available with non-affiliated banks at September 30, 2011. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets.

At September 30, 2011, the Bank had borrowings from the FHLB system totaling $25.0 million which mature through March 28, 2013. The interest rate on these notes payable ranged from 0.13% to 1.91% and the weighted average rate was 0.71%. The Bank had collateral pledged on these borrowings, including real estate loans totaling $63.4 million and FHLB stock with a book value of $2.0 million.

At September 30, 2011, the Bank had a $106 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%.

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Note 6. Capital Requirements

A comparison of the capital of the Company and the Bank at September 30, 2011 and December 31, 2010 with the minimum regulatory guidelines were as follows:

			(dollars in thousands)		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Actual		Minimum Capital Requirement			
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2011:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 57,005	13.62%	$ 33,486	8.00%	N/A	N/A
First Bank	$ 56,376	13.48%	$ 33,448	8.00%	$ 41,811	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 51,609	12.33%	$ 16,744	4.00%	N/A	N/A
First Bank	$ 50,986	12.19%	$ 16,724	4.00%	$ 25,086	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 51,609	9.56%	$ 21,588	4.00%	N/A	N/A
First Bank	$ 50,986	9.43%	$ 21,638	4.00%	$ 27,047	5.00%
December 31, 2010:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 63,163	14.18%	$ 35,624	8.00%	N/A	N/A
First Bank	$ 62,550	14.06%	$ 35,584	8.00%	$ 44,480	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 57,467	12.91%	$ 17,812	4.00%	N/A	N/A
First Bank	$ 56,861	12.78%	$ 17,792	4.00%	$ 26,688	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 57,467	10.54%	$ 21,810	4.00%	N/A	N/A
First Bank	$ 56,861	10.40%	$ 21,859	4.00%	$ 27,324	5.00%

Note 7. 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, 2011 was 2.95%. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is $5.2 million of the Company s junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, $4.0 million of trust preferred securities were issued through a pooled underwriting. The

securities have a LIBOR-indexed floating rate of interest. The interest rate at September 30, 2011 was

1.97%. 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.

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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, 2011, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital.

Note 8. Benefit Plans

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank s funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

Components of the net periodic benefit cost of the plan for the three and nine months ended September 30, 2011 and 2010 were as follows:

	(in thousands)			
	For the three months ended September 30,		For the nine months ended September 30,	
	2011	2010	2011	2010
Service cost	$ 90	$ 77	$ 270	$ 231
Interest cost	77	71	231	213
Expected return on plan assets	(85)	(78)	(255)	(234)
Amortization of prior service cost	1	1	3	3
Amortization of net obligation at transition		(1)		(3)
Amortization of net loss	9	5	27	15
Net periodic benefit cost	$ 92	$ 75	$ 276	$ 225

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

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. The Bank also maintains a Split Dollar Life Insurance Plan that provides life insurance coverage to insurable directors. See Note 11 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 for additional information about the Company s benefit plans.

Note 9. Earnings (Loss) per Common Share

Basic earnings (loss) per common share represents income (loss) available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. There are no potential common shares that would have a dilutive effect. Shares not committed to be released under the Company s leveraged ESOP are not considered to be outstanding. See Note 11 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 for additional information about the Company s leveraged ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 2,955,649 and 2,941,750 for the three months ended September 30, 2011 and 2010, respectively, and 2,952,568 and 2,937,402 for the nine months ended September 30, 2011 and 2010, respectively.

Note 10. Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurement and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, fair value estimates may not be realized in an immediate settlement of the instrument.

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

In accordance with this guidance, the Company groups its assets and liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1	Valuation is based on quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
Level 2	Valuation is based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
Level 3	Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires a significant management judgment or estimation.

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

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

Securities available for sale

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

The following tables present the balances of financial assets measured at fair value on a recurring basis as of September 30, 2011 and December 31, 2010.

Description	Balance as of September 30, 2011	Fair Value Measurements at September 30, 2011 (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				
U.S. agency and mortgage-backed securities	$ 71,673	$	$ 71,673	$
Obligations of states and political subdivisions	13,671		13,671	
Corporate equity securities	116	116		
	$ 85,460	$ 116	$ 85,344	$

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Description	Balance as of December 31, 2010	Fair Value Measurements at December 31, 2010 *(in thousands)* Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				
U.S. agency and mortgage-backed securities	$ 46,924	$	$ 46,924	$
Obligations of states and political subdivisions	13,301		13,301	
Corporate equity securities	195	195		
	$ 60,420	$ 195	$ 60,225	$

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

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

Loans held for sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the nine months ended September 30, 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 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.

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

	0000000000000	0000000000000	0000000000000	0000000000000
		Carrying Value at September 30, 2011 *(in thousands)*		
Description	Balance as of September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	$ 20,491	$	$ 15,327	$ 5,164

	0000000000000	0000000000000	0000000000000	0000000000000
		Carrying Value at December 31, 2010 *(in thousands)*		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	$ 25,552	$	$ 17,584	$ 7,968

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

	0000000000000	0000000000000	0000000000000	0000000000000
		Carrying Value at September 30, 2011 *(in thousands)*		
Description	Balance as of September 30, 2011	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

		(Level 1)		
Assets				
Other real estate owned	$ 5,576	$	$ 5,576	$

	0000000000000	0000000000000	0000000000000	0000000000000
		Carrying Value at December 31, 2010 (in thousands)		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Other real estate owned	$ 3,961	$	$ 3,961	$

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

Cash and Cash Equivalents

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

Loans

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

Deposit Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Borrowings

The carrying amounts of federal funds purchased and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of all other borrowings are estimated using discounted cash flow analyses based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

Commitments and Unfunded Credits

The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2011 and December 31, 2010, fair value of loan commitments and standby letters of credit was immaterial.

The estimated fair values of the Company s financial instruments at September 30, 2011 and December 31, 2010 were as follows:

	(in thousands)			
	September 30, 2011		**December 31, 2010**	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and short-term investments	$ 22,725	$ 22,725	$ 23,497	$ 23,497
Securities	85,460	85,460	60,420	60,420
Loans, net	390,706	394,157	418,994	420,011
Loans held for sale			271	271
Accrued interest receivable	1,660	1,660	1,667	1,667
Financial Liabilities				
Deposits	$ 458,022	$ 438,466	$ 463,500	$ 433,300
Other borrowings	25,106	25,220	20,122	20,400
Trust preferred capital notes	9,279	9,353	9,279	9,279
Accrued interest payable	440	440	551	551

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

Note 11. Capital Purchase Program

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

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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, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or othe terms are intended to identify forward-looking statements. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

- the Company may be adversely affected by economic conditions in the market area;
- risks inherent in the loan portfolio such as repayment risks, fluctuating collateral values and concentrations;
- the adequacy of the allowance for loan losses related to changes in general economic and business conditions in the market area;
- successful management of credit risk including certain concentrations in loans secured by real estate or to certain industry;
- the adequacy of the valuation allowance for other real estate owned related to changes in economic conditions and local real estate activity;
- the reliance on secondary sources, such as Federal Home Loan Bank advances, sales of securities and loans, federal funds lines of credit from correspondent banks and out-of-market time deposits, to meet liquidity needs;
- the ability to raise capital as needed;
- the successful management of interest rate risk;
- potential impact on the Company of legislation;
- difficult market conditions in the Company s industry; and
- other factors identified in Item 1A. Risk Factors of the Company s Form 10-K for the year ending December 31, 2010.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition and results of operations of the Company for the three and nine month periods ended September 30, 2011 should be read in conjunction with the consolidated financial statements and related notes included in Part I, Item 1, of this Form 10-Q and in Part II, Item 8, of the Form 10-K for the period ending December 31, 2010. The results of operations for the three and nine month periods ended September 30, 2011 may not be indicative of the results to be achieved for the year.

Executive Overview

The Company

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

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

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

Products, Services, Customers and Locations

The Bank s primary market area is located within the northern Shenandoah Valley region of Virginia, including Shenandoah County, Warren County, Frederick County and the City of Winchester. Within the market area there are various types of industry including medical and professional services, manufacturing, retail and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

The Bank provides loan, deposit, investment, trust and asset management and other products and services in the northern Shenandoah Valley region of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, NOW accounts, money market accounts, IRA accounts, certificates of deposit and cash management accounts. The Bank offers other services, including internet banking, mobile banking, remote deposit capture and other traditional banking services.

The Bank s Trust and Asset Management Department offers a variety of trust and asset management services including estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement and benefit plans. The Bank offers financial planning and brokerage services for its customers through its investment division, First Financial Advisors.

The Bank s products and services are provided through 10 branch offices, 30 ATMs and its website, www.therespowerinone.com. The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank s financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank s market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2010.

Revenue Sources and Expense Factors

The primary source of revenue is from net interest income earned by the Bank. Net interest income is the difference between interest income and interest expense and typically represents between 75% to 80% of the Company s total revenue. Interest income is determined by the amount of interest-earning assets outstanding during the period and the interest rates earned on those assets. The Bank s interest expense is a function of the amount of interest-bearing liabilities outstanding during the period and the interest rates paid. In addition to net interest income, noninterest income is the other source of revenue for the Company. Noninterest income is derived primarily from service charges on loans and deposits and fees earned from other services. The Bank generates fee income from other services that include trust and investment advisory services and through the origination and sale of residential mortgages.

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by factors that include loan growth, asset quality, net charge-offs and economic conditions. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company s control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the nine month period ended September 30, 2011 was salaries and employee benefits, comprising 47% of noninterest expenses, followed by occupancy and equipment expense, comprising 14% of noninterest expenses.

Focus on Asset Quality

The Company s third quarter results reflect efforts to address asset quality issues. A primary goal of the Bank is to improve asset quality by reducing the balance of impaired loans and nonperforming assets. Management worked towards this goal during the third quarter of 2011 by strengthening weak loans where possible and by increasing specific loan loss reserves on impaired loans to reflect liquidation plans where credit enhancements were simply not available. The Bank has also written down the value of other real estate owned to reflect more aggressive liquidation plans. Total nonperforming assets increased to $28.3 million at quarter end, compared to $19.4 million at June 30, 2011 and $15.5 million at September 30, 2010. The increase in nonperforming asset balances resulted from additional loans placed on nonaccrual status during the third quarter. These loans had been previously identified by management as having certain weaknesses requiring management attention, but the Bank determined that a change in status to nonaccrual was prudent given management s expectations about the customers ability to meet contractual obligations.

The Bank recently created a new department to focus on special assets and anticipates that it will be fully functional in the fourth quarter of 2011. In addition, the Bank is centralizing its lending function in conjunction with the introduction of improved underwriting and risk grading tools. Management continues to carefully monitor the loan portfolio in an effort to manage further deterioration.

Management was successful in strengthening the Bank s collateral position for certain large problem loans during the third quarter. However, there were other previously identified loans that could not be strengthened where repayment ability was in question. As a result, the allowance for loan losses increased from specific reserves on impaired loans and higher levels of nonaccrual loans. Although there have been few new problem loans for some time, several existing customers have simply become unable to continue meeting the terms of their loans. In these situations, the Company has prepared for the sale of collateral to repay such loans.

Quarterly Performance

During the third quarter 2011, the Company recorded $5.6 million in provision for loan losses and $927 thousand in provision for other real estate owned, which contributed to the third quarter loss of $2.9 million. After the effective dividend on preferred stock, net loss available to common shareholders was $3.1 million, or $1.05 per basic and diluted share, compared to net income available to common shareholders of $473 thousand, or $0.16 per basic and diluted share, for the same period in 2010. Net interest income and noninterest income were 2% lower from the third quarter of 2010 while noninterest expense, excluding the provision for other real estate owned, was 2% higher when comparing the two periods. Return on assets and return on equity were -2.11% and -23.78%, respectively, for the third quarter of 2011 compared to 0.51% and 4.92% for the same quarter in 2010.

Comparing the quarter ended September 30, 2011 to the same period in 2010, net interest income totaled $5.0 million which was 2% lower when compared to the same quarter of 2010. Average interest-earning assets were $2.2 million higher when comparing the two periods. The net interest margin was 3.98% for the third quarter of 2011, compared to 4.10% for the same period in 2010. The decline in the margin resulted from a change in the earning asset mix and higher levels of nonaccrual loans.

The provision for loan losses totaled $5.6 million in the third quarter of 2011 compared to $1.2 million for the same period in 2010. Net charge-offs were $851 thousand for the third quarter of 2011 compared to $240 thousand for the same period in 2010. The allowance for loan losses totaled $18.5 million or 4.52% of total loans at September 30, 2011, compared to $8.6 million or 1.96% of total loans at September 30, 2010. The higher provision was related to increased specific reserves on impaired loans and higher levels of nonaccrual loans. Management regularly evaluates the loan portfolio, economic conditions and other factors to determine an appropriate allowance for loan losses. As a result of those evaluations, management believes the allowance for loan losses was appropriate at September 30, 2011.

Noninterest income totaled $1.5 million for the third quarter of 2011, which was 2% lower when compared to the same quarter of 2010. Increases in ATM, check card and trust and investment advisory fee income partially offset a decrease in service charges on deposit accounts, which decreased from lower overdraft fee income. Noninterest expense, excluding the provision for other real estate owned, was $4.5 million for the third quarter of 2011, compared to $4.4 million for the same quarter of 2010, resulting in an efficiency ratio of 68.16% compared to 65.30% for the prior year period.

Year-to-Date Performance

For the nine months ended September 30, 2011, net loss totaled $2.8 million compared to net income of $2.5 million for the same period in 2010. After the effective dividend on preferred stock, net loss available to common shareholders was $3.5 million, or $1.18 per basic and diluted share, compared to net income available to common shareholders of $1.8 million, or $0.61 per basic and diluted share, for the same period in 2010. The decrease in earnings for the nine months ended September 30, 2011 was primarily the result of a $7.7 million increase in the provision for loan losses and other real estate owned when comparing the periods. Return on assets was -0.69% for the nine months ended September 30, 2011 compared to 0.60% for the same period in 2010, and return on equity was -7.75% for the nine months ended September 30, 2011 compared to 5.91% for the same period in 2010.

Net interest income was 1% lower at $15.1 million for the nine months ended September 30, 2011 compared to $15.2 million for the same period in 2010. The net interest margin was 11 basis points lower while average interest-earning assets were $8.7 million higher when comparing the two periods. The net interest margin was 3.96% for the nine months ended September 30, 2011, compared to 4.07% for the same period in 2010. The decline in the margin resulted from a change in the earning asset mix and higher levels of nonaccrual loans.

For the nine months ended September 30, 2011, the loan loss provision totaled $9.4 million compared to $2.6 million for the same period in 2010. During 2011, the provision for loan losses was a result of increased specific reserves on impaired loans and higher net charge-offs. Net charge-offs were $6.9 million for the first nine months of 2011 compared to $1.1 million for the same period in 2010. During 2010, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

Noninterest income decreased 2% to $4.3 million for the nine months ended September 30, 2011 from $4.4 million for the same period in 2010. Increases in ATM, check card and trust and investment advisory fees were partially offset by a decrease in overdraft fee income. Noninterest expense was relatively unchanged for the nine months ended September 30, 2011, compared to the same period in 2010, when excluding the provision for other real estate owned. The provision for other real estate owned totaled $1.1 million for the nine months ended September 30, 2011 compared to $151 thousand for the same period in 2010.

Management Outlook

The Company does not expect a significant change in noninterest expense (excluding the provision for OREO) for the remainder of 2011 and for 2012, when compared to third quarter results. Net interest income is expected to decrease slightly from downward pressure on the net interest margin. Although total average earning asset balances are expected to remain relatively stable during the remainder of 2011 and during 2012, a continuing change in the earning asset mix is anticipated, which should result in a lower net interest margin. The Company is not anticipating that economic conditions will improve significantly in the local market, which is expected to result in low loan demand and deposit growth. The low loan demand is likely to change the earning asset mix by decreasing loan balances and increasing securities balances.

Noninterest income is expected to increase slightly during the fourth quarter of 2011 and during 2012, when compared to third quarter results, from higher service charges on deposit accounts. The Bank modified its deposit products at the end of the third quarter, which included new service charges on deposit accounts when balances fall below a minimum amount.

Management believes that the allowance for loan losses currently provides prudent coverage of the risks in the loan portfolio, and that the carrying value of other real estate owned reflects current market conditions and the Bank s disposition plans. However, the amount of provision for loan losses will be influenced by changes in the Bank s loan customers ability to pay which is affected by real estate values, economic conditions, and other factors. In addition, the amount of the provision for other real estate owned and gains or losses that may occur from the sale of other real estate owned will be impacted by changes in real estate values.

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Non-GAAP Financial Measures

The Company measures the net interest margin as an indicator of profitability. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax-equivalent net interest income is considered in the calculation of this ratio. Tax-equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2011 and 2010 is 34%. The reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below.

Reconciliation of Net Interest Income to

Tax-Equivalent Net Interest Income

(in thousands)

	For the three months ended		For the nine months ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
GAAP measures:				
Interest income - loans	$ 5,666	$ 6,239	$ 17,317	$ 18,728
Interest income - investments and other	737	551	2,061	1,770
Interest expense - deposits	1,204	1,397	3,810	4,574
Interest expense - other borrowings	42	104	175	356
Interest expense - other	109	113	327	341
Total net interest income	$ 5,048	$ 5,176	$ 15,066	$ 15,227
Non-GAAP measures:				
Tax benefit realized on non-taxable interest income - loans	$ 14	$ 13	$ 40	$ 33
Tax benefit realized on non-taxable interest income - municipal securities	62	69	188	216
Total tax benefit realized on non-taxable interest income	$ 76	$ 82	$ 228	$ 249
Total tax-equivalent net interest income	$ 5,124	$ 5,258	$ 15,294	$ 15,476

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

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.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management s periodic review of the collectibility 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. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revisions as more information becomes available. The evaluation also considers the following risk characteristics of each loan portfolio:

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 will not be finished according to schedule, the project will 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 precision.

Consumer 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.

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 when appropriate.

The general component relates to loans that are not considered impaired. These unimpaired loans are segregated by loan type 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 recognizes 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.

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 secured loans up to $1.5 million and unsecured loans up to $1.2 million. The Management Loan Committee consists of the Chief Executive Officer (CEO), Executive Vice President (EVP) Loan Administration and the Senior Vice President (SVP) Credit Administration. The Board Loan Committee approves all loans which exceed the authority of the Management Loan Committee. The Board Loan Committee consists of five non-management directors. The Board Loan Committee approves the Bank s Loan Policy and reviews loans that have been charged-off. It also reviews the loan watch list, concentrations of

credit and other 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 loans and commercial real estate loan originations are obtained through broker referrals, direct solicitation of developers and continued business from 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. Information is also obtained to evaluate cash flow available for debt service. 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.

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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, 2011, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled $57.2 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 precision as 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. At September 30, 2011 and December 31, 2010, commercial loans not secured by real estate totaled $32.6 million or 8% of total loans and $40.7 million, or 9% of total loans, respectively.

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. At September 30, 2011, commercial real estate loans totaled $195.5 million or 48% of the Bank s total loans, as compared to $207.4 million, or 48%, at December 31, 2010. 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. 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 and the borrower s creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers principal owners and carefully evaluates the location and environmental condition of the real estate collateral. To further mitigate risk, the Company monitors loan concentrations within the commercial real estate portfolio, including hotel loans, which totaled $35.1 million, or 9%, of the Bank s total loans at September 30, 2011 compared to $41.6 million, or 10%, of total loans at December 31, 2010.

Construction 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. Construction and land development loans outstanding at September 30, 2011 and December 31, 2010, were $49.3 million, or 12% of total loans, and $52.6 million, or 12% of total loans, respectively. 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 often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. 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, 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. Typically, the Bank originates all 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. At September 30, 2011, $120.0 million, or 29%, of total loans consisted of residential real estate loans as compared to $121.5 million, or 28%, at December 31, 2010.

In connection with residential real estate loans, the Bank requires title insurance, hazard insurance and, where applicable, flood insurance. Flood determination letters with life of loan tracking are obtained on all federally related transactions with improvements serving as security for the transaction. The Bank does require escrows for real estate taxes and insurance for secondary market loans.

The Company does not participate in sub-prime lending practices so issues in the residential mortgage market from sub-prime lending have not had, and are not expected to have, a direct impact on earnings. Nevertheless, the Company is subject to risks associated with general economic and business conditions in its market area, as well as the condition of the regional residential mortgage market, each of which has been impacted by sub-prime lending and related issues.

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, including deposit overdraft balances, totaled $11.7 million, or 3% of total loans, at September 30, 2011 compared to $12.9 million, or 3% of total loans, at December 31, 2010. 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, premises and equipment and other real estate owned; general and administrative expenses; and income tax expense.

During the third quarter 2011, the Company recorded $5.6 million in provision for loan losses and $927 thousand in provision for other real estate owned, which contributed to a loss of $2.9 million. After the effective dividend on preferred stock, net loss available to common shareholders was $3.1 million, or $1.05 per basic and diluted share, compared to net income available to common shareholders of $473 thousand, or $0.16 per basic and diluted share, for the same period in 2010. Net interest income and noninterest income were 2% lower than the third quarter of 2010 while noninterest expense, excluding the provision for other real estate owned, was 2% higher when comparing the two periods. Return on assets and return on equity were -2.11% and -23.78%, respectively, for the third quarter of 2011 compared to 0.51% and 4.92% for the same quarter in 2010.

For the nine months ended September 30, 2011, net loss totaled $2.8 million compared to net income of $2.5 million for the same period in 2010. After the effective dividend on preferred stock, net loss available to common shareholders was $3.5 million, or $1.18 per basic and diluted share, compared to net income available to common shareholders of $1.8 million, or $0.61 per basic and diluted share, for the same period in 2010. The decrease in earnings for the nine months ended September 30, 2011 was primarily the result of a $7.7 million increase in the provisions for loan losses and other real estate owned when comparing the periods. Return on assets was -0.69% for the nine months ended September 30, 2011 compared to 0.60% for the same period in 2010, and return on equity was -7.75% for the nine months ended September 30, 2011 compared to 5.91% for the same period in 2010.

Net Interest Income

Net interest income totaled $5.0 million for the third quarter of 2011, a 2% decrease from $5.2 million for the same period in 2010. Average interest-earning assets were $2.2 million higher when comparing the two periods. The net interest margin was 3.98% for the third quarter of 2011, compared to 4.10% for the same period in 2010. The decline in the margin resulted from a change in the earning asset mix and higher levels of nonaccrual loans. Loan balances were lower and cash, due from banks, federal funds sold and securities balances were higher in the third quarter of 2011 when compared to the same quarter in 2010.

Net interest income was 1% lower at $15.1 million for the nine months ended September 30, 2011 compared to $15.2 million for the same period in 2010. The net interest margin was 11 basis points lower while average interest-earning assets were $8.7 million higher when comparing the two periods. The net interest margin was 3.96% for the nine months ended September 30, 2011, compared to 4.07% for the same period in 2010.

Net interest income is expected to decrease slightly during the remainder of 2011 and during 2012 from downward pressure on the net interest margin. Although total average earning asset balances are expected to remain relatively stable, a continuing change in the earning asset mix is anticipated, which should result in a lower net interest margin. The Company is not planning for economic conditions to improve significantly in the local market, which is expected to result in low loan demand and deposit growth. The low loan demand is likely to change the earning asset mix by decreasing loan balances and increasing securities balances.

Provision for Loan Losses

The provision for loan losses totaled $5.6 million in the third quarter of 2011 compared to $1.2 million for the same period in 2010. Net charge-offs were $851 thousand for the third quarter of 2011 compared to $240 thousand for the same period in 2010. The allowance for loan losses totaled $18.5 million or 4.52% of total loans at September 30, 2011, compared to $8.6 million or 1.96% of total loans at September 30, 2010. The higher provision was related to increases in specific reserves on impaired loans and higher levels of nonaccrual loans.

For the nine months ended September 30, 2011, the loan loss provision totaled $9.4 million compared to $2.6 million for the same period in 2010. During 2011, the provision for loan losses was a result of increases in specific reserves on impaired loans and higher net charge-offs. Net charge-offs were $6.9 million for the first nine months of 2011 compared to $1.1 million for the same period in 2010. During 2010, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

Management believes that the allowance for loan losses currently provides prudent coverage of the risks in the loan portfolio. However, the amount of provision for loan losses will be influenced by the Bank s loan customers ability to pay which is affected by changes in real estate values, economic conditions, and other factors.

Noninterest Income

Noninterest income totaled $1.5 million for the third quarter of 2011, which was 2% lower when compared to the same quarter of 2010. Service charges on deposit accounts decreased $78 thousand, or 12%, to $590 thousand for the third quarter of 2011 compared to $668 thousand for the same quarter of 2010. The decrease in service charges on deposit accounts was related to lower overdraft fee income. Net gains on sales of loans decreased $51 thousand, or 67%, for the third quarter of 2011 compared to $76 thousand for the same quarter of 2010. Trust and investment advisory fees increased $20 thousand, or 6%, to $350 thousand for the third quarter of 2011 compared to $330 thousand for the same quarter of 2010. In addition, ATM and check card fees increased $13 thousand, or 3%, to $391 thousand for the third quarter of 2011, compared to $378 thousand for the same period in 2010. This was related to an increase in ATM and check card transactions during the quarter.

Noninterest income decreased 2% to $4.3 million for the nine months ended September 30, 2011 from $4.4 million for the same period in 2010. Increases in ATM, check card and trust and investment advisory fees were offset by a decrease in overdraft fee income.

Noninterest income is expected to increase slightly during the fourth quarter of 2011 and during 2012, when compared to third quarter results, from higher service charges on deposit accounts. The Bank modified its deposit products at the end of the third quarter, which included new service charges on deposit accounts when balances fall below a minimum amount.

Noninterest Expense

Noninterest expense, excluding the provision for other real estate owned, totaled $4.5 million for the third quarter of 2011 compared to $4.4 million for the same period in 2010, resulting in an efficiency ratio of 68.16% compared to 65.30% for the prior year period.

The Company does not expect a significant change in noninterest expense, excluding provision for other real estate owned, for the remainder of 2011. Management believes that the carrying value of other real estate owned reflects current market conditions and the Bank s disposition plans. However, the amount of provision for other real estate owned will be influenced by changes in real estate values and economic conditions, among other factors. In addition, gains or losses that may occur from the sale of other real estate owned will be impacted by changes in real estate values.

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 and nine month periods ended September 30, 2011 and 2010. 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 9 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

Financial Condition

General

Total assets were $541.5 million at September 30, 2011 compared to $544.6 million at December 31, 2010. The Company s trust and investment advisory group had assets under management of $210.4 million at September 30, 2011 compared to $205.5 million at December 31, 2010. Assets managed by the trust and investment advisory group are not held on the Company s balance sheet.

The Company is not planning for economic conditions to improve significantly in the local market, which should result in low loan demand and deposit growth. As a result, the earning asset mix is expected to change as loan balances continue decreasing while balances of securities increase.

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; 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: 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 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.

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.

The Company has a credit concentration in mortgage loans on real estate. These loans totaled $364.8 million, or 89% of total loans at September 30, 2011 and $381.5 million, or 88% of total loans at December 31, 2010. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations is influenced by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled $35.1 million at September 30, 2011, representing 76% of total equity and 9% of total loans. At December 31, 2010, this concentration totaled $41.6 million representing 86% of total shareholders equity and 10% of total loans. These loans are included in other real estate loans in the table found in Note 3 of the notes to consolidated financial statements of this Form 10-Q. The Company charged down $2.0 million related to this concentration of credit risk during the nine month period ended September 30, 2011 and $147 thousand during the year ended December 31, 2010. The Company analyzes this concentration by performing interest rate and vacancy rate stress tests on a quarterly basis. In addition, occupancy reports are evaluated monthly to identify performance trend lines.

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 nonaccrual 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 nonaccrual 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 nonaccrual 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 and doubtful loans greater than $500 thousand 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 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 nonaccrual status at the time of the TDR, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above.

Asset Quality

Management classifies as nonperforming assets nonaccrual 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 $5.6 million in OREO, net of the valuation allowance, at September 30, 2011 and $4.0 million at December 31, 2010. The valuation allowance for other real estate owned totaled $4.0 million at September 30, 2011 and $3.3 million at December 31, 2010. During the third quarter, the Bank wrote down the value of OREO to reflect more aggressive liquidation plans. The provision for OREO totaled $927 thousand for the third quarter of 2011, compared to $111 thousand for the same quarter a year ago. For the nine months ended September 30, 2011, the provision for OREO totaled $1.1 million compared to $151 thousand for the same period of 2010.

Nonperforming assets were $28.3 million at September 30, 2011, $14.8 million at December 31, 2010 and $15.5 million at September 30, 2010, representing 5.22%, 2.71% and 2.86% of total assets, respectively. Nonperforming assets included $22.7 million in nonaccrual loans and $5.6 million in OREO, net of the valuation allowance at September 30, 2011.

The levels of nonperforming assets in 2011 and 2010 were primarily attributable to weaker 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 retail operations and residential real estate development. The increase in nonperforming assets at September 30, 2011 resulted from loans placed on nonaccrual status. These loans had been previously identified by management as having certain weaknesses requiring management attention, but the Bank determined that a change in status to nonaccrual was prudent given management s expectations about its loan customers ability to meet contractual obligations. At September 30, 2011, 52% of nonperforming assets related to commercial real estate loans, 25% related to residential development loans, 16% related to residential real estate loans and 7% related to commercial and industrial loans not secured by real estate. Nonperforming assets could increase due to other potential problem loans identified by management. 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 $48.6 million and $73.3 million at September 30, 2011 and December 31, 2010, 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 $18.5 million at September 30, 2011 and $16.0 million at December 31, 2010, representing 4.52% and 3.69% of total loans, respectively.

Impaired loans totaled $45.2 million and $43.9 million at September 30, 2011 and December 31, 2010, respectively. The related allowance for loan losses provided for these loans totaled $10.7 million and $8.6 million at September 30, 2011 and December 31, 2010, respectively. The average recorded investment in impaired loans during the nine months ended September 30, 2011 and the year ended December 31, 2010 was $39.1 million and $22.3 million, respectively. Included in the impaired loans total at September 30, 2011 are loans classified as TDRs totaling $13.2 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, 2011, $6.2 million of these TDRs were performing under the restructured terms and were not considered nonperforming 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, 2011 were $85.4 million, an increase of $25.0 million, or 41%, from $60.4 million at December 31, 2010. 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, 2011, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios.

Deposits

Deposits were $458.0 million at September 30, 2011, a decrease of 1% from $463.5 million at December 31, 2010. Savings and interest-bearing demand deposits increased $11.7 million or 7% to $190.4 at September 30, 2011 compared to $178.7 million at December 31, 2010. Non-interest bearing demand deposits increased $2.8 million or 4% to $81.8 million during the first nine months of 2011 from $79.0 million at December 31, 2010. Time deposits, which include brokered deposits, decreased $20.1 million or 10% during the first nine months of 2011 to $185.8 million compared to $205.9 million at December 31, 2010.

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, 2011, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, loans maturing within one year, and expected maturities, calls and principal repayments from the securities portfolio within one year totaled $115.4 million. At September 30, 2011, 23% or $92.3 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled $121.5 million at September 30, 2011, which included $77.8 million available from FHLB, $40.0 million of unsecured federal funds lines of credit with other correspondent banks and $3.7 million available through the Federal Reserve Discount Window. During the first nine months of 2011, other borrowing activity included repayment of a fixed rate advance from FHLB totaling $10.0 million and borrowing Daily Rate Credit advances as an alternative to purchasing federal funds.

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 13.61% at September 30, 2011 and a ratio of Tier 1 capital to risk-weighted assets of 12.32%. Both 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 for the first five years, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock

pays cumulative dividends at a rate of 9% per annum from the date of issuance.

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, 2010.

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 $47.9 million at September 30, 2011, and $53.4 million at December 31, 2010, 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, 2011 and December 31, 2010, the Bank had $8.3 million and $6.9 million in outstanding standby letters of credit, respectively.

The Company had $918 thousand in locked-rate commitments to originate mortgage loans at September 30, 2011 and none at December 31, 2010. 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.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a company s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures were required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

The SEC has issued Final Rule No. 33-9002, Interactive Data to Improve Financial Reporting , which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011. The Company complied with this Rule beginning with the filing of the June 30, 2011 Form 10-Q.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB s Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

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In April 2011, the FASB issued ASU 2011-02, A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring. The amendments in this ASU clarify the guidance on a creditor s evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor s evaluation of whether a debtor is experiencing financial difficulty. The amendments in this Update are effective for the first interim or annual period beginning on or after June 15, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company has adopted ASU 2011-02 and included the required disclosures in its 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 IFRS. This ASU is the result of joint efforts by the FASB and 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 IFRS. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company is currently assessing the impact that ASU 2011-04 will have on 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 stockholders equity. The amendments require that all non-owner changes in stockholders 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 are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

In August 2011, the SEC issued Final Rule No. 33-9250, Technical Amendments to Commission Rules and Forms related to the FASB s Accounting Standards Codification. The SEC has adopted technical amendments to various rules and forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. These revisions were necessary to conform those rules and forms to the FASB Accounting Standards Codification. The technical amendments include revision of certain rules in Regulation S-X, certain items in Regulation S-K, and various rules and forms prescribed under the Securities Act, Exchange Act and Investment Company Act. The Release was effective as of August 12, 2011. The adoption of the release did not have a material impact on the Company s consolidated financial statements.

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. An evaluation of the effectiveness of the design and operation of the Company s disclosure controls and procedures as of September 30, 2011 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.

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, 2010 and Quarterly Report on Form 10-Q for the period ended June 30, 2011.

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

None

Item 3. Defaults upon Senior Securities

None

Item 4. Removed and Reserved

Item 5. Other Information

None

Item 6. Exhibits

The following documents are attached hereto as Exhibits:

3.1	Bylaws, as restated in electronic format only as of August 3, 2011 (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed with the SEC on August 9, 2011).
31.1	Certification of Chief Executive Officer, Section 302 Certification
31.2	Certification of Chief Financial Officer, Section 302 Certification
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, 2011 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Changes in Shareholders Equity, and (v) 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	November 10, 2011
Scott C. Harvard	Date
President and Chief Executive Officer	
/s/ M. Shane Bell	November 10, 2011
M. Shane Bell	Date
Executive Vice President and Chief Financial Officer	

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EXHIBIT INDEX

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