FIRST NATIONAL CORP /VA/
Form 10-K
March 27, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2014

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)**

Registrant s telephone number, including area code: (540) 465-9121

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $1.25 par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this Chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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. (Check one):

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing sales price on June 30, 2014 was $27,643,395.

The number of outstanding shares of common stock as of March 20, 2015 was 4,909,714.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for the 2015 Annual Meeting of Shareholders Part III

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Part I

Cautionary Statement Regarding Forward-Looking Statements

First National Corporation (the Company) makes forward-looking statements in this Form 10-K that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, adequacy of capital, allowance for loan losses, interest rate sensitivity, market risk, growth strategy and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, foreca other similar words or terms are intended to identify forward-looking statements. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

- conditions in the financial markets and economic conditions may adversely affect the Company s business;
- the inability of the Company to successfully manage its growth or implement its growth strategy;
- difficulties in combining the operations of acquired bank branches or entities with the Company s own operations;
- intense competition from other financial institutions both in making loans and attracting deposits;
- consumers may increasingly decide not to use the Bank to complete their financial transactions;
- limited availability of financing or inability to raise capital;
- exposure to operational, technological, and organizational risk;
- reliance on other companies to provide key components of their business infrastructure;
- the Company s credit standards and its on-going credit assessment processes might not protect it from significant credit losses;
- operational functions of business counterparties over which the Company may have limited or no control may experience disruptions;

- nonperforming assets take significant time to resolve and adversely affect the Company s results of operations and financial condition;
- allowance for loan losses may prove to be insufficient to absorb losses in the loan portfolio;
- the concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets;
- legislative or regulatory changes or actions, or significant litigation;
- the limited trading market for the Company s common stock; it may be difficult to sell shares;
- unexpected loss of management personnel;
- losses that could arise from breaches in cyber-security;
- increases in FDIC insurance premiums could adversely affect the Company s profitability;
- the ability to retain customers and secondary funding sources if the Bank s reputation would become damaged;
- changes in interest rates could have a negative impact on the Company s net interest income and an unfavorable impact on the Bank s customers ability to repay loans; and
- other factors identified in Item 1A, Risk Factors , below.

Because of these and other 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.

Item 1. Business
General

First National Corporation (the Company) is a bank holding company incorporated under Virginia law on September 7, 1983. The Company owns all of the stock of its primary operating subsidiary, First Bank (the Bank), which is a commercial bank chartered under Virginia law. The Company s subsidiaries are:

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)

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

The Bank first opened for business on July 1, 1907 under the name The Peoples National Bank of Strasburg. On January 10, 1928, the Bank changed its name to The First National Bank of Strasburg. On April 12, 1994, the Bank received approval from the Federal Reserve Bank of Richmond (the Federal Reserve) and the Virginia State Corporation Commission s Bureau of Financial Institutions to convert to a state chartered bank with membership in the Federal Reserve System. On June 1, 1994, the Bank consummated such conversion and changed its name to First Bank.

Access to Filings

The Company s internet address is www.fbvirginia.com. The Company s Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to those reports, as filed with or furnished to the Securities and Exchange Commission (the SEC), are available free of charge at www.fbvirginia.com as soon as reasonably practicable after being filed with or furnished to the SEC. A copy of any of the Company s filings will be sent, without charge, to any shareholder upon written request to: M. Shane Bell, Chief Financial Officer, at 112 West King Street, Strasburg, Virginia 22657.

Products and Services

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

The Bank provides loan, deposit, wealth management and other products and services in the 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 wealth management division offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement, 401(k) and benefit plans. In addition, the division offers financial planning and brokerage services to individuals throughout the Bank s market area.

The Bank launched a new mortgage division named First Mortgage during the second quarter of 2014. The mortgage division began originating residential mortgage loans to customers in the third quarter of 2014. The majority of loans originated in future periods are expected to be sold to investors in the secondary market. First Mortgage offers mortgage services to customers throughout the Shenandoah Valley of Virginia.

The Bank s products and services are provided through 10 branch offices, 1 customer service center, 2 loan production offices, 25 ATMs and its website, www.fbvirginia.com. Upon the completion of a pending branch acquisition scheduled to close in April 2015, the Bank expects to add four branch office locations in the Shenandoah Valley region of Virginia located in Woodstock, Staunton, Waynesboro and Elkton, and two branch offices in central

Virginia located in Farmville and Dillwyn. After the transaction closes, the Bank expects to operate a total of 16 branch offices with approximately $750 million in total assets. The loan production offices were opened during 2014 and are located in Staunton and Harrisonburg, Virginia. The Bank operates six of its branch 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, and wealth management personnel to be readily available to serve customers throughout the Bank s market area. For the location of each of these Financial Centers, see Item 2 of this Form 10-K.

Competition

The financial services industry remains highly competitive and is constantly evolving. The Company experiences strong competition in all aspects of its business. In its market areas, the Company competes with large national and regional financial institutions, credit unions, other independent community banks, as well as consumer finance companies, mortgage companies, loan production offices, mutual funds and life insurance companies. Competition has increasingly come from out-of-state

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banks through their acquisitions of Virginia-based banks. Competition for deposits and loans is affected by various factors including interest rates offered, the number and location of branches and types of products offered, and the reputation of the institution. Credit unions have been allowed to increasingly expand their membership definitions and, because they enjoy a favorable tax status, may be able to offer more attractive loan and deposit pricing.

The Company believes its competitive advantages include long-term customer relationships, local management and directors, a commitment to excellent customer service, dedicated and loyal employees, and the support of and involvement in the communities that the Company serves. The Company focuses on providing products and services to individuals, small to medium-sized businesses and local governmental entities within its communities. According to Federal Deposit Insurance Corporation (FDIC) deposit data as of June 30, 2014, the Bank was ranked first in Shenandoah County with $226.5 million in deposits, representing 30% of the total deposit market; third in Warren County with $50.2 million or 11% of the market; and fourth in Winchester and Frederick County with $179.1 million or 9% of the market. The Bank was ranked third overall in its market area with 14% of the total deposit market.

No material part of the business of the Company is dependent upon a single or a few customers, and the loss of any single customer would not have a materially adverse effect upon the business of the Company.

Employees

At December 31, 2014, the Company and the Bank employed a total of 156 full-time equivalent employees. The Company considers relations with its employees to be excellent.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively and increasingly regulated under both federal and state laws. The following description briefly addresses certain historic and current provisions of federal and state laws and certain regulations, proposed regulations, and the potential impacts on the Company and the Bank. To the extent statutory or regulatory provisions or proposals are described in this report, the description is qualified in its entirety by reference to the particular statutory or regulatory provisions or proposals.

Regulatory Reform   The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the   Dodd-Frank Act   ), enacted in 2010, implemented and continues to implement significant changes to the regulation of the financial services industry, including provisions that, among other things:

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Consumer Financial Protection Bureau (CFPB), with broad rulemaking, supervisory and enforcement authority with respect to a wide range of consumer protection laws that generally apply to all banks and thrifts. Smaller financial institutions, including the Bank, continue to be subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.

- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to bank holding companies.

Require the FDIC to seek to make its capital requirements for banks countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.

Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital.

Implement corporate governance revisions, including advisory votes on executive compensation by stockholders.

Established extensive requirements applicable to mortgage lending, including detailed requirements concerning mortgage originator compensation and underwriting, high-cost mortgages, servicing, appraisals, counseling and other matters.

Make permanent the $250,000 limit for federal deposit insurance.

Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

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The Dodd-Frank Act amends the Bank Holding Company Act of 1956, as amended (the BHCA) to require the federal financial regulatory agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). The statutory provision is commonly called the Volcker Rule . The Federal Reserve Board issued final rules implementing the Volcker Rule on December 10, 2013. The Volcker Rule became effective on July 21, 2012 and the final rules were effective April 1, 2014, but the Federal Reserve Board issued an order extending the period during which institutions have to conform their activities and investments to the requirements of the Volcker Rule to July 21, 2017. We do not currently anticipate that the Volcker Rule will have a material effect on the operations of the holding company or the Bank, as we generally do not engage in activities or hold investments impacted by the Volcker Rule.

Many aspects of the Dodd-Frank Act still remain subject to rulemaking by various regulatory agencies and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry more generally. The changes resulting from the Dodd-Frank Act may affect the profitability of business activities, require changes to certain business practices, impose more stringent capital requirements, liquidity and leverage ratio requirements, or otherwise adversely affect the business of the Company and the Bank. These changes may also require the Company to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and regulatory requirements.

The Company

General. As a bank holding company registered under the BHCA, the Company is subject to supervision, regulation, and examination by the Federal Reserve. The Company is also registered under the bank holding company laws of Virginia and is subject to supervision, regulation, and examination by the Virginia State Corporation Commission (the SCC).

Permitted Activities. A bank holding company is limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the Federal Reserve determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the Federal Reserve must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the Federal Reserve has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding company may result from such an activity.

Banking Acquisitions; Changes in Control. The BHCA requires, among other things, the prior approval of the Federal Reserve in any case where a bank holding company proposes to (i) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless it already owns a majority of such voting shares), (ii) acquire all or substantially all of the assets of another bank or bank holding company, or (iii) merge or consolidate with any other bank holding company. In determining whether to approve a proposed bank acquisition, the Federal Reserve will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution s performance under the Community Reinvestment Act of 1977 (the CRA).

Subject to certain exceptions, the BHCA and the Change in Bank Control Act, together with the applicable regulations, require Federal Reserve approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company s acquiring control of a bank or bank holding company. A conclusive presumption of control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered securities under Section 12 of the Securities Exchange Act of 1934 (the Exchange Act) or no other person will own a greater percentage of that class of voting securities immediately after the acquisition. The Company s common stock is registered under Section 12 of the Exchange Act.

Source of Strength. Federal Reserve policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. The federal bank regulatory agencies must still issue regulations to implement the source of strength provisions of the Dodd-Frank Act. Under this requirement, the Company is expected to commit resources to support the Bank, including at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Safety and Soundness. There are a number of obligations and restrictions imposed on bank holding companies and their subsidiary banks by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the Federal Deposit Insurance Corporation (FDIC) insurance fund in the event of a depository institution default. For example, under the Federal Deposit Insurance Company Improvement Act of 1991, to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any subsidiary bank that may become undercapitalized with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal bank regulatory agency up to the lesser of (i) an amount equal to 5% of the institution s total assets at the time the institution became undercapitalized, or (ii) the amount that is necessary (or would have been necessary) to bring the institution into compliance with all applicable capital standards as of the time the institution fails to comply with such capital restoration plan.

Under the Federal Deposit Insurance Act (FDIA), the federal bank regulatory agencies have adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines.

Capital Requirements. The Federal Reserve imposes certain capital requirements on bank holding companies under the BHCA, including a minimum leverage ratio and a minimum ratio of qualifying capital to risk-weighted assets. These requirements are described below under The Bank-Capital Requirements . Subject to its capital requirements and certain other restrictions, the Company is able to borrow money to make a capital contribution to the Bank, and such loans may be repaid from dividends paid by the Bank to the Company.

In July 2013, the Federal Reserve Board released its final rules which will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. The new rules were effective January 1, 2015. Under the final rule, minimum requirements will increase for both the quality and quantity of capital held by banking organizations. In this respect, the final rule implements strict eligibility criteria for regulatory capital instruments and improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Consistent with the international Basel framework, the rule includes a new minimum ratio of Common Equity Tier 1 Capital to Risk-Weighted Assets of 4.5% and a Common Equity Tier 1 Capital conservation buffer of 2.5% of risk-weighted assets. The conservation buffer will be phased in from 2016 through 2019. The rule also, among other things, raises the minimum ratio of Tier 1 Capital to Risk-Weighted Assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations.

We have evaluated the impact of the Basel III final rule on the Company s consolidated regulatory capital ratios and currently anticipate that its capital ratios, on a Basel III basis, will be sufficient to meet the well capitalized minimum capital requirements.

Limits on Dividends and Other Payments. The Company is a legal entity, separate and distinct from its subsidiaries. A significant portion of the revenues of the Company result from dividends paid to it by the Bank. There are various legal limitations applicable to the payment of dividends by the Bank to the Company and to the payment of dividends by the Company to its shareholders. The Bank is subject to various statutory restrictions on its ability to pay dividends to the Company. Under the current supervisory practices of the Bank s regulatory agencies, prior approval from those agencies is required if cash dividends declared in any given year exceed net income for that year, plus retained net profits of the two preceding years. The payment of dividends by the Bank or the Company may be limited by other factors, such as requirements to maintain capital above regulatory guidelines. Bank regulatory agencies have the authority to prohibit the Bank or the Company from engaging in an unsafe or unsound practice in conducting their business. The payment of dividends, depending on the financial condition of the Bank, or the Company, could be deemed to constitute such an unsafe or unsound practice.

The Company s preferred stock is in a superior ownership position compared to common stock. Dividends must be paid to the preferred stock holder before they can be paid to the common shareholders. If the dividends on the Preferred Stock have not been paid for an aggregate of six (6) quarterly dividend periods or more, whether or not consecutive, the Company s authorized number of directors will be automatically increased by two (2) and the holders of the Preferred Stock will have the right to elect those directors at the Company s next annual meeting or at a special meeting called for that purpose; these two directors may be elected annually and may serve until all accrued and unpaid dividends for all past dividend periods have been declared and paid in full. The Company is current on all dividend payments on the Preferred Stock.

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The Bank

General. The Bank is supervised and regularly examined by the Federal Reserve and the SCC. The various laws and regulations administered by the regulatory agencies affect corporate practices, such as the payment of dividends, incurrence of debt, and acquisition of financial institutions and other companies; they also affect business practices, such as the payment of interest on deposits, the charging of interest on loans, types of business conducted, and location of offices. Certain of these law and regulations are referenced above under The Company.

Capital Requirements. The Federal Reserve and the other federal banking agencies have issued risk-based and leverage capital guidelines applicable to U. S. banking organizations. In addition, those regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its financial condition or actual or anticipated growth. Under the risk-based capital requirements of the Federal Reserve, the Company and the Bank are required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8.0%. At least half of the total capital is required to be Tier 1 capital, which consists principally of common and certain qualifying preferred shareholders equity (including grandfathered trust preferred securities), less certain intangibles and other adjustments. The remainder (Tier 2 capital) consists of a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. The Tier 1 and total capital to risk-weighted asset ratios of the Company were 18.67% and 19.93%, respectively, as of December 31, 2014, thus exceeding the minimum requirements. The Tier 1 and total capital to risk-weighted asset ratios of the Bank were 17.88% and 19.14%, respectively, as of December 31, 2014, also exceeding the minimum requirements.

Each of the federal regulatory agencies has established a minimum leverage capital ratio of Tier 1 capital to average adjusted assets (Tier 1 leverage ratio). These guidelines provide for a minimum Tier 1 leverage ratio of 4% for banks and bank holding companies that meet certain specified criteria, including having the highest regulatory examination rating and are not contemplating significant growth or expansion. As of December 31, 2014, the Tier 1 leverage ratios of the Company and the Bank were 13.47% and 12.90%, respectively, well above the minimum requirements. The guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets.

The Bank will also be subject to the new Basel III capital rules discussed above. We have evaluated the impact of the Basel III final rule on the Bank s regulatory capital ratios and currently anticipate that its capital ratios will be sufficient to meet the well capitalized minimum capital requirements.

Deposit Insurance. Substantially all of the deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. On April 1, 2011, the deposit insurance assessment base changed from total deposits to average total assets minus average tangible equity, pursuant to a rule issued by the FDIC as required by the Dodd-Frank Act.

The FDIA, as amended by the Federal Deposit Insurance Reform Act and the Dodd-Frank Act, requires the FDIC to set a ratio of deposit insurance reserves to estimated insured deposits of at least 1.35%. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank s capital level and supervisory rating. On February 7, 2011, the FDIC introduced three possible adjustments to an institution s initial base assessment rate: (i) a decrease of up to five basis points for long-term unsecured debt, including senior unsecured debt (other than debt guaranteed under the Temporary Liquidity Guarantee Program) and subordinated debt and, for small institutions, a portion of Tier 1 capital; (ii) an increase for holding long-term unsecured or subordinated debt issued by other insured depository institutions known as the Depository Institution Debt Adjustment or DIDA;

and (iii) for non-Risk Category I institutions, an increase not to exceed 10 basis points for brokered deposits in excess of 10% of domestic deposits.

In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately one basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2017 through 2019.

Transactions with Affiliates. Pursuant to Sections 23A and 23B of the Federal Reserve Act and Regulation W, the authority of the Bank to engage in transactions with related parties or affiliates or to make loans to insiders is limited. Loan transactions with an affiliate generally must be collateralized and certain transactions between the Bank and its affiliates, including the sale of assets, the payment of money or the provision of services, must be on terms and conditions that are substantially the same, or at least as favorable to the Bank, as those prevailing for comparable nonaffiliated transactions. In addition, the Bank generally may not purchase securities issued or underwritten by affiliates.

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Loans to executive officers, directors or to any person who directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote more than 10% of any class of voting securities of a bank (a 10% Shareholder), are subject to Sections 22(g) and 22(h) of the Federal Reserve Act and their corresponding regulations (Regulation O) and Section 13(k) of the Exchange Act relating to the prohibition on personal loans to executives (which exempts financial institutions in compliance with the insider lending restrictions of Section 22(h) of the Federal Reserve Act). Among other things, these loans must be made on terms substantially the same as those prevailing on transactions made to unaffiliated individuals and certain extensions of credit to those persons must first be approved in advance by a disinterested majority of the entire board of directors. Section 22(h) of the Federal Reserve Act prohibits loans to any of those individuals where the aggregate amount exceeds an amount equal to 15% of an institution s unimpaired capital and surplus plus an additional 10% of unimpaired capital and surplus in the case of loans that are fully secured by readily marketable collateral, or when the aggregate amount on all of the extensions of credit outstanding to all of these persons would exceed the Bank s unimpaired capital and unimpaired surplus. Section 22(g) of the Federal Reserve Act identifies limited circumstances in which the Bank is permitted to extend credit to executive officers.

Prompt Corrective Action. Immediately upon becoming undercapitalized, a depository institution becomes subject to the provisions of Section 38 of the FDIA, which: (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution s assets; and (v) require prior approval of certain expansion proposals. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the DIF, subject in certain cases to specified procedures. These discretionary supervisory actions include: (i) requiring the institution to raise additional capital; (ii) restricting transactions with affiliates; (iii) requiring divestiture of the institution or the sale of the institution to a willing purchaser; and (iv) any other supervisory action that the agency deems appropriate. These and additional mandatory and permissive supervisory actions may be taken with respect to significantly undercapitalized and critically undercapitalized institutions. The Bank meets the definition of being well capitalized as of December 31, 2014.

Community Reinvestment Act. The Bank is subject to the requirements of the Community Reinvestment Act of 1977. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of the local communities, including low and moderate income neighborhoods. If the Bank receives a rating from the Federal Reserve of less than satisfactory under the CRA, restrictions on operating activities could be imposed.

Privacy Legislation. Several recent regulations issued by federal banking agencies also provide new protections against the transfer and use of customer information by financial institutions. A financial institution must provide to its customers information regarding its policies and procedures with respect to the handling of customers personal information. Each institution must conduct an internal risk assessment of its ability to protect customer information. These privacy provisions generally prohibit a financial institution from providing a customer s personal financial information to unaffiliated parties without prior notice and approval from the customer.

USA Patriot Act of 2001. In October 2001, the USA Patriot Act of 2001 (Patriot Act) was enacted in response to the September 11, 2001 terrorist attacks. The Patriot Act is intended to strengthen U. S. law enforcement and the intelligence communities abilities to work cohesively to combat terrorism. The continuing impact on financial institutions of the Patriot Act and related regulations and policies is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws, and imposes various regulations, including standards for verifying customer identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities to identify persons who may be involved in terrorism or money laundering.

Consumer Laws and Regulations. The Bank is also subject to certain consumer laws and regulations issued thereunder that are designed to protect consumers in transactions with banks. These laws include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Housing Act and the Dodd-Frank Act, among others. The laws and related regulations mandate certain disclosure requirements and regulate the manner in which financial institutions transact business with customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations.

Incentive Compensation. In June 2010, the federal banking agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of financial institutions do not undermine the safety and soundness of such institutions by encouraging excessive risk-taking. The *Interagency Guidance on Sound Incentive Compensation Policies*, which covers all employees that have the ability to materially affect the risk profile of a financial institution, either individually or as part of a group, is based upon the key principles that a financial institution s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the institution s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the financial institution s board of directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Company, that are not large, complex banking organizations. These reviews will be tailored to each financial institution based on the scope and complexity of the institution s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the institution s supervisory ratings, which can affect the institution s ability to make acquisitions and take other actions. Enforcement actions may be taken against a financial institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the institution s safety and soundness and the financial institution is not taking prompt and effective measures to correct the deficiencies. At December 31, 2014, the Company had not been made aware of any instances of non-compliance with the guidance.

Effect of Governmental Monetary Policies

The Company s operations are affected not only by general economic conditions but also by the policies of various regulatory authorities. In particular, the Federal Reserve regulates money and credit conditions and interest rates to influence general economic conditions. These policies have a significant impact on overall growth and distribution of loans, investments and deposits; they affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks, including the Company, in the past and are expected to do so in the future.

Item 1A. Risk Factors

An investment in the Company s securities involves risks. In addition to the other information set forth in this report, investors in the Company s securities should carefully consider the factors discussed below. These factors could materially and adversely affect the Company s business, financial condition, liquidity, results of operations and capital position, and could cause the Company s actual results to differ materially from its historical results or the results contemplated by the forward-looking statements contained in this report, in which case the trading price of the Company s securities could decline.

Risks Related To The Company s Business

The Company s business may be adversely affected by conditions in the financial markets and economic conditions generally.

The community banking industry is directly affected by national, regional, and local economic conditions. The economies in the Company s market areas continued to show improvement during 2014. Management allocates significant resources to mitigate and respond to risks associated with the current economic conditions, however, such conditions cannot be predicted or controlled. Therefore, such conditions, including a reduction in federal government spending, a flatter yield curve, and extended low interest rates, could adversely affect the credit quality of the Company s loans, and/or the Company s results of operations and financial condition. The Company s financial performance is dependent on the business environment in the markets where the Company operates, in particular, the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services the Company offers. In addition, the Company holds securities which can be significantly affected by various factors including credit ratings assigned by third parties. An adverse credit rating in securities held by the Company could result in a reduction of the fair value of its securities portfolio and have an adverse impact on its financial condition. While general economic conditions in Virginia and the U.S. continued to improve in 2014, there can be no assurance that this improvement will continue.

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The inability of the Company to successfully manage its growth or implement its growth strategy may adversely affect the Company s results of operations and financial conditions.

The Company may not be able to successfully implement its growth strategy if it is unable to expand market share in existing locations, identify attractive markets, locations, or opportunities to expand in the future. In addition, the ability to manage growth successfully depends on whether the Company can maintain adequate capital levels, maintain cost controls, effectively manage asset quality, and successfully integrate any expanded business divisions or acquired businesses into the organization.

As the Company continues to implement its growth strategy by opening new branches or acquiring branches or banks, it expects to incur increased personnel, occupancy, and other operating expenses. In the case of new branches, the Company must absorb those higher expenses while it begins to generate new deposits. In the case of acquired branches, the Company must absorb higher expenses while it begins deploying the newly assumed deposit liabilities. With either new branches opened or branches acquired, there would be a time lag involved in deploying new deposits into attractively priced loans and other higher yielding earning assets. Thus, the Company s plans to expand could depress earnings in the short run, even if it efficiently executes a branching strategy leading to long-term financial benefits.

Difficulties in combining the operations of acquired bank branches or entities with the Company s own operations may prevent the Company from achieving the expected benefits from acquisitions.

The Company may not be able to achieve fully the strategic objectives and operating efficiencies expected in an acquisition. Inherent uncertainties exist in integrating the operations of an acquired entity. In addition, the markets and industries in which the Company and its potential acquisition targets operate are highly competitive. The Company may lose customers or the customers of acquired entities as a result of an acquisition; the Company may lose key personnel, either from the acquired entity or from itself; and the Company may not be able to control the incremental increase in noninterest expense arising from an acquisition in a manner that improves its overall operating efficiencies. These factors could contribute to the Company s not achieving the expected benefits from its acquisitions within desired time frames, if at all. Future business acquisitions could be material to the Company and it may issue additional shares of common stock to support those acquisitions, which would dilute current shareholders ownership interests. Acquisitions also could require the Company to use substantial cash or other liquid assets or to incur debt; the Company could therefore become more susceptible to economic downturns and competitive pressures.

The Company faces substantial competition that could adversely affect the Company s growth and/or operating results.

The Company operates in a competitive market for financial services and faces intense competition from other financial institutions both in making loans and attracting deposits which can greatly affect pricing for its products and services. The Company s primary competitors include community, regional, and national banks as well as credit unions and mortgage companies. Many of these financial institutions have been in business for many years, are significantly larger, have established customer bases and have greater financial resources and higher lending limits. In addition, credit unions are exempt from corporate income taxes, providing a significant competitive pricing advantage. Accordingly, some of the Company s competitors in its market have the ability to offer products and services that it is unable to offer or to offer at more competitive rates.

Consumers may increasingly decide not to use the Bank to complete their financial transactions, which would have a material adverse impact on the Company s financial condition and operations.

Technology and other changes are allowing parties to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts, mutual funds or general-purpose reloadable prepaid cards. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

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The Company s mortgage revenue is cyclical and is sensitive to the level of interest rates, changes in economic conditions, decreased economic activity, and slowdowns in the housing market, any of which could adversely impact the Company s profits.

The success of the Bank s mortgage division is dependent upon its ability to originate loans and sell them to investors. Loan production levels are sensitive to changes in the level of interest rates and changes in economic conditions. Loan production levels may suffer if the Bank experiences a slowdown in the local housing market or tightening credit conditions. Any sustained period of decreased activity caused by fewer refinancing transactions, higher interest rates, housing price pressure or loan underwriting restrictions would adversely affect the Bank s mortgage originations and, consequently, could significantly reduce its income from mortgage activities. As a result, these conditions would also adversely affect the Company s results of operations.

Deteriorating economic conditions may also cause home buyers to default on their mortgages. In certain cases where the Bank has originated loans and sold them to investors, the Bank may be required to repurchase loans or provide a financial settlement to investors if it is proven that the borrower failed to provide full and accurate information on, or related to, their loan application, if appraisals for such properties have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor. Such repurchases or settlements would adversely affect the Company s results of operations.

The carrying value of goodwill may be adversely affected.

When a Company completes an acquisition, often times, goodwill is recorded on the date of acquisition as an asset. Current accounting guidance requires goodwill to be tested for impairment; the Company would perform such impairment analysis at least annually. A significant adverse change in expected future cash flows or sustained adverse change in the Company s common stock could require the asset to become impaired. If impaired, the Company would incur a charge to earnings that would have a significant impact on the results of operations.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the performance of the Bank s fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Bank s fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on the Company s financial condition and results of operations.

The Company depends on the accuracy and completeness of information about clients and counterparties, and its financial condition could be adversely affected if it relies on misleading information.

In deciding whether to extend credit or to enter into other transactions with clients and counterparties, the Company may rely on information furnished to it by or on behalf of clients and counterparties, including financial statements and other financial information, which the Company does not independently verify. The Company also may rely on representations of clients and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to clients, the Company may assume that a customer s audited financial statements conform to GAAP and present fairly, in all material respects, the financial condition, results of operations, and cash flows of the customer. The Company s financial condition and results of operations could be negatively impacted to the extent it relies on financial statements that do not comply with GAAP or are materially misleading.

The Company s dependency on its management team and the unexpected loss of any of those personnel could adversely affect operations.

The Company has assembled an experienced management team and continues to build the depth of that team. Although management development plans are in place, the unexpected loss of key employees could have a material adverse effect on the Company s business and may result in lower revenues or greater expenses.

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Failure to maintain effective systems of internal and disclosure controls could have a material adverse effect on the Company s results of operation and financial condition.

Effective internal and disclosure controls are necessary for the Company to provide reliable financial reports and effectively prevent fraud, and to operate successfully as a public company. If the Company cannot provide reliable financial reports or prevent fraud, its reputation and operating results would be harmed. As part of the Company s ongoing monitoring of internal controls, it may discover material weaknesses or significant deficiencies in its internal control that require remediation. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a company s annual or interim financial statements will not be prevented or detected on a timely basis.

The Company continually works on improving its internal controls. However, the Company cannot be certain that these measures will ensure that it implements and maintains adequate controls over its financial processes and reporting. Any failure to maintain effective controls or to timely implement any necessary improvement of the Company s internal and disclosure controls could, among other things, result in losses from fraud or error, harm the Company s reputation, or cause investors to lose confidence in the Company s reported financial information, all of which could have a material adverse effect on the Company s results of operation and financial condition.

Negative public opinion could damage our reputation and adversely impact liquidity and profitability.

As a financial institution, the Company s earnings, liquidity, and capital are subject to risks associated with negative public opinion of the Company and of the financial services industry as a whole. Negative public opinion could result from our actual or alleged conduct in any number of activities, including lending practices, the failure of any product or service sold by us to meet our clients expectations or applicable regulatory requirements, corporate governance and acquisitions, or from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect our ability to keep, attract and/or retain customers and can expose us to litigation and regulatory action. Actual or alleged conduct by one of our businesses can result in negative public opinion about our other businesses. Negative public opinion could also affect our ability to borrow funds in the unsecured wholesale debt markets.

Changes in interest rates could adversely affect the Company s income and cash flows.

The Company s income and cash flows depend to a great extent on the difference between the interest rates earned on interest-earning assets, such as loans and investment securities, and the interest rates paid on interest-bearing liabilities, such as deposits and borrowings. These rates are highly sensitive to many factors beyond the Company s control, including general economic conditions and the policies of the Federal Reserve and other governmental and regulatory agencies. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the prepayment of loans, the purchase of investments, the generation of deposits, and the rates received on loans and investment securities and paid on deposits or other sources of funding. The impact of these changes may be magnified if the Company does not effectively manage the relative sensitivity of its assets and liabilities to changes in market interest rates. In addition, the Company s ability to reflect such interest rate changes in pricing its products is influenced by competitive pressures. Fluctuations in these areas may adversely affect the Company and its shareholders. The Bank is often at a competitive disadvantage in managing its costs of funds compared to the large regional, super-regional, or national banks that have access to the national and international capital markets.

The Company generally seeks to maintain a neutral position in terms of the volume of assets and liabilities that mature or re-price during any period so that it may reasonably maintain its net interest margin; however, interest rate fluctuations, loan prepayments, loan production, deposit flows, and competitive pressures are constantly changing and influence the ability to maintain a neutral position. Generally, the Company s earnings will be more sensitive to fluctuations in interest rates depending upon the variance in volume of assets and liabilities that mature and re-price in any period. The extent and duration of the sensitivity will depend on the cumulative variance over time, the velocity and direction of changes in interest rates, shape and slope of the yield curve, and whether the Company is more asset sensitive or liability sensitive. Accordingly, the Company may not be successful in maintaining a neutral position and, as a result, the Company s net interest margin may be affected.

Limited availability of financing or inability to raise capital could adversely impact the Company.

The amount, type, source, and cost of the Company s funding and capital directly impacts the ability to grow assets. The ability to raise funds through deposits, borrowings and other sources, or raise capital could become more difficult, more expensive, or altogether unavailable. A number of factors could make such financing more difficult, more expensive or unavailable including: the financial condition of the Company at any given time; rate disruptions in the capital markets; the reputation for soundness and security of the financial services industry as a whole; and, competition for funding from other banks or similar financial service companies, some of which could be substantially larger or be more favorably rated.

The soundness of other financial institutions could adversely affect the Company.

The Company s ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by the Company or by other institutions. Many of these transactions expose the Company to credit risk in the event of default of its counterparty or client. There is no assurance that any such losses would not materially and adversely affect the Company s results of operations.

The Company s exposure to operational, technological, and organizational risk may adversely affect the Company.

Similar to other financial institutions, the Company is exposed to many types of operational and technological risk, including reputation, legal, and compliance risk. The Company s ability to grow and compete is dependent on its ability to build or acquire the necessary operational and technological infrastructure and to manage the cost of that infrastructure while it expands and integrates acquired businesses. Operational risk can manifest itself in many ways, such as errors related to failed or inadequate processes, faulty or disabled computer systems, occurrences of fraud by employees or persons outside of the Company, and exposure to external events. The Company is dependent on its operational infrastructure to help manage these risks. From time to time, it may need to change or upgrade its technology infrastructure. The Company may experience disruption, and it may face additional exposure to these risks during the course of making such changes. If the Company would acquire another financial institution or bank branch operations, it would face additional challenges when integrating different operational platforms. Such integration efforts may be more disruptive to the business and/or more costly than anticipated.

The Company and the Bank rely on other companies to provide key components of their business infrastructure.

Third parties provide key components of the Company s (and the Bank s) business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections, and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problem caused by these third parties, including poor performance of services, failure to provide services, disruptions in communication services provided by a vendor and failure to handle current or higher volumes, could adversely affect the Company s ability to deliver products and services to its customers and otherwise conduct its business, and may harm its reputation. Financial or operational difficulties of a third party vendor could also hurt the Company s operations if those difficulties affect the vendor s ability to serve the Company. Replacing these third party vendors could also create significant delay and expense. Accordingly, use of such third parties creates an unavoidable inherent risk to the Company s business operations.

The operational functions of business counterparties over which the Company may have limited or no control may experience disruptions that could adversely impact the Company.

Multiple major U.S. retailers have recently experienced data systems incursions reportedly resulting in the thefts of credit and debit card information, online account information, and other financial data of the retailers customers. Retailer incursions affect cards issued and deposit accounts maintained by many banks, including the Bank. Although neither the Company s nor the Bank s systems are breached in retailer incursions, these events can cause the Bank to reissue a significant number of cards and take other costly steps to avoid significant theft loss to the Bank and its customers. In some cases, the Bank may be required to reimburse customers for the losses they incur. Other possible points of intrusion or disruption not within the Company s nor the Bank s control include internet service providers, electronic mail portal providers, social media portals, distant-server (cloud) service providers, electronic data security providers, telecommunications companies, and smart phone manufacturers.

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The Company s operations may be adversely affected by cyber security risks.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance, and use of this information is critical to operations and the Company s business strategy. The Company has invested in accepted technologies, and continually reviews processes and practices that are designed to protect its networks, computers, and data from damage or unauthorized access. Despite these security measures, the Company s computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance, or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. A breach in security could result in legal claims, regulatory penalties, disruption in operations, and damage to the Company s reputation, which could adversely affect its business. Furthermore, as cyber threats continue to evolve and increase, the Company may be required to expend significant additional resources to modify or enhance its protective measures, or to investigate and remediate any identified information security vulnerabilities.

Nonperforming assets take significant time to resolve and adversely affect the Company s results of operations and financial condition.

The Company s nonperforming assets adversely affect its net income in various ways. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases loan administration costs. When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related loan to the then fair market value of the collateral less estimated selling costs, which may result in a loss. An increase in the level of nonperforming assets also increases the Company s risk profile and may affect the capital levels that the Company believes are appropriate in light of such risks. The Company utilizes various techniques such as workouts, restructurings, and loan sales to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers performance or financial condition, could adversely affect the Company s business, results of operations, and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including origination of new loans. There can be no assurance that the Company will avoid further increases in nonperforming loans in the future.

The Bank s allowance for loan losses may prove to be insufficient to absorb losses in its loan portfolio.

Like all financial institutions, the Bank maintains an allowance for loan losses to provide for loans that its borrowers may not repay in their entirety. The Bank believes that it maintains an allowance for loan losses at a level adequate to absorb probable losses inherent in the loan portfolio as of the corresponding balance sheet date and in compliance with applicable accounting and regulatory guidance. However, the allowance for loan losses may not be sufficient to cover actual loan losses and future provisions for loan losses could materially and adversely affect the Company s operating results. Accounting measurements related to impairment and the allowance for loan losses require significant estimates that are subject to uncertainty and changes relating to new information and changing circumstances. The significant uncertainties surrounding the ability of the Bank s borrowers to execute their business models successfully through changing economic environments, competitive challenges, and other factors complicate the Bank s estimates of the risk of loss and amount of loss on any loan. Because of the degree of uncertainty and susceptibility of these factors to change, the actual losses may vary from current estimates. The Company expects fluctuations in the loan loss provisions due to the uncertain economic conditions.

The Company s banking regulators, as an integral part of their examination process, periodically review the allowance for loan losses and may require the Bank to increase its allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease the allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such required additional provisions for loan losses or charge-offs could have a material adverse effect on the Company s financial condition and results of operations.

If the Bank s valuation allowance on OREO becomes inadequate, results of operations may be adversely affected.

The Bank maintains a valuation allowance that it believes is a reasonable estimate of known losses in OREO. The Bank obtains appraisals on all OREO properties on an annual basis and adjusts the valuation allowance accordingly. The carrying value of OREO is susceptible to changes in economic and real estate market conditions. Although the Company believes the valuation allowance is a reasonable estimate of known losses, such losses and the adequacy of the allowance cannot be fully predicted. Excessive declines in market values could have a material impact on financial performance.

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The Bank s concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets.

The Bank offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer, and other loans. Many of the Bank s loans are secured by real estate (both residential and commercial) in the Bank s market areas. A major change in the real estate markets, resulting in deterioration in the value of this collateral, or in the local or national economy, could adversely affect borrowers ability to pay these loans, which in turn could negatively affect the Bank. Risks of loan defaults and foreclosures are unavoidable in the banking industry; the Bank tries to limit its exposure to these risks by monitoring extensions of credit carefully. The Bank cannot fully eliminate credit risk; thus, credit losses will occur in the future. Additionally, changes in the real estate market also affect the value of foreclosed assets, and therefore, additional losses may occur when management determines it is appropriate to sell the assets.

The Bank has a significant concentration of credit exposure in commercial real estate, and loans with this type of collateral are viewed as having more risk of default.

The Bank s commercial real estate portfolio consists primarily of owner-operated properties and other commercial properties. These types of loans are generally viewed as having more risk of default than residential real estate loans. They are also typically larger than residential real estate loans and consumer loans and depend on cash flows from the owner s business or the property to service the debt. Cash flows may be affected significantly by general economic conditions, and a downturn in the local economy or in occupancy rates in the local economy where the property is located could increase the likelihood of default. Because the Bank s loan portfolio contains a number of commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in the percentage of non-performing loans. An increase in non-performing loans could result in a loss of earnings from these loans, an increase in the provision for loan losses and an increase in charge-offs, all of which could have a material adverse effect on the Bank s financial condition.

The Bank s banking regulators generally give commercial real estate lending greater scrutiny and may require banks with higher levels of commercial real estate loans to implement improved underwriting, internal controls, risk management policies, and portfolio stress testing, as well as possibly higher levels of allowances for losses and capital levels as a result of commercial real estate lending growth and exposures, which could have a material adverse effect on the Bank s results of operations.

The Bank s loan portfolio contains construction and development loans, and a decline in real estate values and economic conditions would adversely affect the value of the collateral securing the loans and have an adverse effect on the Bank s financial condition.

Although most of the Bank s construction and development loans are secured by real estate, the Bank believes that, in the case of the majority of these loans, the real estate collateral by itself may not be a sufficient source for repayment of the loan if real estate values decline. If the Bank is required to liquidate the collateral securing a construction and development loan to satisfy the debt, its earnings and capital may be adversely affected. A period of reduced real estate values may continue for some time, resulting in potential adverse effects on the Bank s earnings and capital.

The Company s credit standards and its on-going credit assessment processes might not protect it from significant credit losses.

The Company assumes credit risk by virtue of making loans and extending loan commitments and letters of credit. The Company manages credit risk through a program of underwriting standards, the review of certain credit decisions and a continuous quality assessment process of credit already extended. The Company s exposure to credit risk is managed through the use of consistent underwriting standards that emphasize local lending while avoiding highly leveraged transactions as well as excessive industry and other concentrations. The Company s credit administration function employs risk management techniques to help ensure that problem loans are promptly identified. While these procedures are designed to provide the Company with the information needed to implement policy adjustments where necessary and to take appropriate corrective actions, there can be no assurance that such measures will be effective in avoiding undue credit risk.

The Company s focus on lending to small to mid-sized community-based businesses may increase its credit risk.

Most of the Company s commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company s results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle. Any deterioration of the borrowers businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company s financial condition and results of operations.

The Bank relies upon independent appraisals to determine the value of the real estate which secures a significant portion of its loans, and the values indicated by such appraisals may not be realizable if the Bank is forced to foreclose upon such loans.

A significant portion of the Bank s loan portfolio consists of loans secured by real estate. The Bank relies upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment that adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of the Bank s loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, the Bank may not be able to recover the outstanding balance of the loan.

The Dodd-Frank Act substantially changes the regulation of the financial services industry and it could have a material adverse effect upon the Company.

The Dodd-Frank Act provides wide-ranging changes in the way banks and financial services firms generally are regulated and affect the way the Company and its customers and counterparties do business with each other. Among other things, it requires increased capital and regulatory oversight for banks and their holding companies, changes the deposit insurance assessment system, changes responsibilities among regulators, establishes the CFPB, and makes various changes in the securities laws and corporate governance that affect public companies, including the Company. The Dodd-Frank Act also requires numerous studies and regulations related to its implementation. The Company is continually evaluating the effects of the Dodd-Frank Act, together with implementing the regulations that have been proposed and adopted. The ultimate effects of the Dodd-Frank Act and the resulting rulemaking cannot be predicted at this time, but it has increased the Company s operating and compliance costs in the short-term, and it could have a material adverse effect on the Company s results of operation and financial condition.

The Company is subject to more stringent capital and liquidity requirements as a result of the Basel III regulatory capital reforms and the Dodd-Frank Act, the short-term and long-term impact of which is uncertain.

The Company and the Bank are each subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which each must maintain. From time to time, regulators implement changes to these regulatory capital adequacy guidelines. Under the Dodd-Frank Act, the federal banking agencies have established stricter capital requirements and leverage limits for banks and bank holding companies that are based on the Basel III regulatory capital reforms. These stricter capital requirements will be phased-in over a four-year period, which began on January 1, 2015, until they are fully-implemented on January 1, 2019. If the Company and the Bank fail to meet these minimum capital guidelines and/or other regulatory requirements, the Company s financial condition would be materially and adversely affected.

Recent regulations issued by the CFPB could adversely impact the Company s earnings.

The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule effective January 10, 2014, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate qualified mortgages that meet specific requirements with respect to terms, pricing, and fees. The rule also contains additional disclosure requirements at mortgage loan origination and in monthly statements. These requirements could limit the Company s ability to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact the Company s profitability.

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Current and proposed regulation addressing consumer privacy and data use and security could increase the Company s costs and impact its reputation.

The Company is subject to a number of laws concerning consumer privacy and data use and securities, including information safeguard rules under the Gramm-Leach-Bliley Act. These rules require that financial institutions develop, implement, and maintain a written, comprehensive information security program containing safeguards that are appropriate to the financial institution s size and complexity, the nature and scope of the financial institution s activities, and the sensitivity of any customer information at issue. The United States has experienced a heightened legislative and regulatory focus on privacy and data security, including requiring consumer notification in the event of a data breach. In addition, most states have enacted security breach legislation requiring varying levels of consumer notification in the event of certain types of security breaches. New regulations in these areas may increase compliance costs, which could negatively impact earnings. In addition, failure to comply with the privacy and data use and security laws and regulations to which the Company is subject, including by reason of inadvertent disclosure of confidential information, could result in fines, sanctions, penalties, or other adverse consequences and loss of consumer confidence, which could materially adversely affect our results of operations, overall business, and reputation.

Legislative or regulatory changes or actions, or significant litigation, could adversely affect the Company or the businesses in which the Company is engaged.

The Company is subject to extensive state and federal regulation, supervision, and legislation that govern almost all aspects of its operations. Laws and regulations change from time to time and are primarily intended for the protection of consumers, depositors, and the FDIC s DIF. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively affect the Company or its ability to increase the value of its business. Such changes include higher capital requirements, and could include increased insurance premiums, increased compliance costs, reductions of noninterest income, and limitations on services that can be provided. Actions by regulatory agencies or significant litigation against the Company could cause it to devote significant time and resources to defend itself and may lead to liability or penalties that materially affect the Company and its shareholders. Future changes in the laws or regulations or their interpretations or enforcement could be materially adverse to the Company and its shareholders.

See the section of this report entitled Supervision and Regulation for additional information on the statutory and regulatory issues that affect the Company s business.

Changes in accounting standards could impact reported earnings.

The authorities that promulgate accounting standards, including the Financial Accounting Standards Board (FASB), the United States Securities Exchange Commission (the SEC), and other regulatory authorities, periodically change the financial accounting and reporting standards that govern the preparation of the Company s consolidated financial statements. These changes are difficult to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of financial statements for prior periods. Such changes could also require the Company to incur additional personnel or technology costs.

Risks Related To The Company s Securities

The Company s ability to pay dividends depends upon the results of operations of its Bank subsidiary.

The Company is a bank holding company that conducts substantially all of its operations through its subsidiary Bank. As a result, the Company s ability to make dividend payments on its common stock depends primarily on certain federal regulatory considerations and the receipt of dividends and other distributions from the Bank. There are various regulatory restrictions on the ability of the Bank to pay dividends or make other payments to the Company. Although the Company has historically paid a cash dividend to the holders of its common stock, holders of the common stock are not entitled to receive dividends, and regulatory or economic factors may cause the Company s Board of Directors to consider, among other things, the reduction of dividends paid on the Company s common stock.

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There is a limited trading market for the Company s common stock; it may be difficult to sell shares.

The trading volume in the Company s common stock has been relatively limited. Even if a more active market develops, there can be no assurance that a more active and liquid trading market for the common stock will exist in the future. Consequently, shareholders may not be able to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares. In addition, the Company cannot predict the effect, if any, that future sales of its common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock. Sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, could cause the price of the Company s common stock to decline, or reduce the Company s ability to raise capital through future sales of common stock. The lack of liquidity of the investment in the common shares should be carefully considered when making an investment decision.

Future issuances of the Company s common stock could adversely affect the market price of the common stock and could be dilutive.

The Company is not restricted from issuing additional authorized shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, shares of common stock. Issuances of a substantial number of shares of common stock, or the expectation that such issuances might occur, including in connection with acquisitions by the Company, could materially adversely affect the market price of the shares of common stock and could be dilutive to shareholders. Because the Company s decision to issue common stock in the future will depend on market conditions and other factors, it cannot predict or estimate the amount, timing, or nature of possible future issuances of its common stock. Accordingly, the Company s shareholders bear the risk that future issuances will reduce the market price of the common stock and dilute their stock holdings in the Company.

The current economic conditions may cause volatility in the Company s common stock value.

In the current economic environment, the value of publicly traded stocks in the financial services sector has been volatile. However, even in a more stable economic environment the value of the Company s common stock can be affected by a variety of factors such as expected results of operations, actual results of operations, actions taken by shareholders, news or expectations based on the performance of others in the financial services industry, and expected impacts of a changing regulatory environment. These factors not only impact the value of the Company s common stock but could also affect the liquidity of the stock given the Company s size, geographical footprint, and industry.

The Company s preferred stock and trust preferred capital notes (commonly referred to as trust preferred securities) have a preference to our common stock, which may limit our ability to pay dividends on common stock in the future.

Our ability to pay dividends on common stock is also limited by contractual restrictions under its trust preferred securities and preferred stock. Interest must be paid on the trust preferred securities, and dividends must be paid on the preferred stock, before dividends may be paid to the common shareholders. The Company is current in its interest and dividend payments on the trust preferred securities and preferred stock; however, it has the right to defer distributions on these instruments, during which time no dividends may be paid on its common stock. If the Company does not have sufficient earnings in the future and begins to defer distributions on the trust preferred securities or preferred stock, it will be unable to pay dividends on its common stock until it becomes current on those distributions.

The Company s governing documents and Virginia law contain anti-takeover provisions that could negatively affect its shareholders.

The Company s Articles of Incorporation and the Virginia Stock Corporation Act contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the Company. These provisions and the ability to set the voting rights, preferences, and other terms of any series of outstanding preferred stock and preferred stock that may be issued, may be deemed to have an anti-takeover effect and may discourage takeovers (which certain shareholders may deem to be in their best interest). To the extent that such takeover attempts are discouraged, temporary fluctuations in the market price of the Company s common stock resulting from actual or rumored takeover attempts may be inhibited. These provisions also could discourage or make more difficult a merger, tender offer, or proxy contest, even though such transactions may be favorable to the interests of shareholders, and could potentially adversely affect the market price of the Company s common stock.

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Recently enacted legislation could allow the Company to deregister under the Exchange Act, which would result in a reduction in the amount and frequency of publicly-available information about the Company.

The Jumpstart Our Business Startups Act (or JOBS Act) may allow the Company to terminate the registration of its common stock under the Exchange Act. If the Company determines to deregister its common stock under the Exchange Act, it would enable it to save significant expenses relating to its public disclosure and reporting requirements under the Exchange Act. However, a de-registration of common stock also would result in a reduction in the amount and frequency of publicly-available information about the Company and the Bank.

Item 1B. Unresolved Staff Comments

Not applicable.

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Item 2. Properties

The following describes the location and general character of the principal offices of the Company.

The Company owns the headquarters building located at 112 West King Street, in Strasburg, Virginia. This location also serves as the Bank s Strasburg Financial Center, which primarily serves the banking needs of northern Shenandoah County customers. This three story building also houses administrative employees, including human resources and marketing. Loan and deposit operations, data processing and information technology employees are housed in the Operations Center. Financial accounting and additional administrative employees are housed in the Winchester Financial Center. Financial centers provide full service banking, including loan, deposit, wealth management services, while the bank branches primarily focus on depository and consumer lending functions. The Bank operates a Customer Service Center located within The Village at Orchard Ridge retirement community. The following table provides the name, location, year opened and type of the Company s locations:

Name	Location	Year Opened	Type	Owned/Leased
Strasburg Financial Center	112 West King Street Strasburg, Virginia	1927	Financial Center	Owned
Front Royal Express	508 North Commerce Avenue Front Royal, Virginia	1985	Branch	Leased
Kernstown Express	3143 Valley Pike Winchester, Virginia	1994	Branch	Owned
South Woodstock	860 South Main Street Woodstock, Virginia	1995	Branch	Owned
North Woodstock	496 North Main Street Woodstock, Virginia	1999	Branch	Leased
Front Royal Financial Center	1717 Shenandoah Avenue Front Royal, Virginia	2002	Financial Center	Owned
Winchester Financial Center	1835 Valley Avenue Winchester, Virginia	2003	Financial Center	Owned
Mount Jackson Financial Center	5304 Main Street Mount Jackson, Virginia	2004	Financial Center	Owned
Sherando Financial Center	695 Fairfax Pike Stephens City, Virginia	2006	Financial Center	Owned

Winchester West Financial Center	208 Crock Wells Mill Drive Winchester, Virginia	2006	Financial Center	Owned
Operations Center	406 Borden Mowery Drive Strasburg, Virginia	2008	Operations Center	Owned
The Village at Orchard Ridge Customer Service Center	400 Clocktower Ridge Drive Winchester, Virginia	2013	Customer Service Center	Leased
Staunton Loan Production Office	1600 North Coalter Street, Suite 10 Staunton, Virginia	2014	Loan Production Office	Leased
Harrisonburg Loan Production Office	727-C East Market Street Harrisonburg, Virginia	2014	Loan Production Office	Leased

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Rental expense for the leased locations totaled $60 thousand for the year ended December 31, 2014. The initial term for the lease for the Front Royal Express property expired and the tenancy is considered to be month-to-month. The lease for the North Woodstock property expires on May 31, 2016, without a renewal option. The initial term for the lease for the Village at Orchard Ridge space expired but has an automatic renewal option every twelve months. The lease for the Staunton Loan Production Office property expires on March 31, 2019 with a renewal option through March 31, 2024. The lease for the Harrisonburg Loan Production Office property expires on December 31, 2015, without a renewal option. All of the Company s properties are in good operating condition and are adequate for the Company s present and future needs.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or to which the property of the Company is subject.

Item 4. Mine Safety Disclosures

None.

Part II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Prices and Dividends

Shares of the common stock of the Company are traded on the over-the-counter (OTC) market and quoted on the OTC Markets Group exchange under the symbol FXNC. As of March 20, 2015 the Company had 608 shareholders of record and approximately 576 additional beneficial owners of shares of common stock.

Following are the high and low prices of sales of common stock known to the Company, along with the dividends that were paid quarterly in 2013 and 2014 (per share).

	Market Prices and Dividends		
	Sales Price ($)		Dividends ($)
	High	Low	
2013:			
1st quarter	7.00	5.00	0.00
2nd quarter	7.50	5.75	0.00
3rd quarter	7.00	4.55	0.00
4th quarter	5.85	4.55	0.00
2014:			
1st quarter	7.80	5.65	0.00
2nd quarter	7.99	7.30	0.025

3rd quarter	8.90	7.35	0.025
4th quarter	8.65	7.85	0.025

Dividend Policy

A discussion of certain limitations on the ability of the Bank to pay dividends to the Company and the ability of the Company to pay dividends on its common and preferred stock, is set forth in Part I., Item 1 Business, of this Form 10-K under the headings Supervision and Regulation Limits on Dividends and Other Payments and Item 1A Risk Factors, The Company s preferred stock and trust preferred capital notes (commonly referred to as trust preferred securities) are superior to our common stock, which may limit our ability to pay dividends on common stock in the future.

In the second quarter of 2014, the Company resumed payment of dividends on its common stock. The Company s future dividend policy is subject to the discretion of its Board of Directors and will depend upon a number of factors, including future earnings, financial condition, liquidity and capital requirements of both the Company and the Bank, applicable governmental regulations and policies and other factors deemed relevant by the Board of Directors.

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Stock Repurchases

The Company did not repurchase any shares of its common stock during 2014.

Item 6. Selected Financial Data

The following is selected financial data for the Company for the last five years. This information has been derived from audited financial information included in Item 8 of this Form 10-K (in thousands, except ratios and per share amounts).

	For the years ended December 31,				
	2014	2013	2012	2011	2010
Results of Operations					
Interest and dividend income	$ 20,399	$ 21,157	$ 23,432	$ 25,648	$ 27,215
Interest expense	1,778	2,709	4,167	5,450	6,814
Net interest income	18,621	18,448	19,265	20,198	20,401
Provision for (recovery of) loan losses	(3,850)	(425)	3,555	12,380	11,731
Net interest income after provision for (recovery of) loan losses	22,471	18,873	15,710	7,818	8,670
Noninterest income	7,444	6,931	7,172	5,799	6,082
Noninterest expense	18,785	20,750	19,117	20,743	20,561
Income (loss) before income taxes	11,130	5,054	3,765	(7,126)	(5,809)
Income tax expense (benefit)	3,499	(4,820)	965	3,835	(2,206)
Net income (loss)	7,631	9,874	2,800	(10,961)	(3,603)
Effective dividend and accretion on preferred stock	1,138	913	904	894	887
Net income (loss) available to common shareholders	$ 6,493	$ 8,961	$ 1,896	$ (11,855)	$ (4,490)
Key Performance Ratios					
Return on average assets	1.45%	1.85%	0.53%	(1.96%)	(0.66%)
Return on average equity	13.49%	21.87%	6.80%	(22.46%)	(6.52%)
Net interest margin	3.86%	3.72%	3.89%	3.98%	4.07%
Efficiency ratio(1)	74.03%	74.86%	70.07%	69.66%	66.77%
Dividend payout	5.67%	0.00%	0.00%	(5.30%)	(36.64%)
Equity to assets	11.50%	10.24%	8.43%	6.88%	8.90%
Per Common Share Data					
Net income (loss), basic and diluted	$ 1.32	$ 1.83	$ 0.48	$ (4.01)	$ (1.53)
Cash dividends	0.075	0.00	0.00	0.20	0.56
Book value at period end	9.17	7.96	6.22	7.72	11.66
Financial Condition					
Assets	$ 518,165	$ 522,890	$ 532,697	$ 539,064	$ 544,629
Loans, net	371,692	346,449	370,519	379,503	418,994
Securities	83,292	103,301	89,456	91,665	60,420
Deposits	444,338	450,711	466,917	469,172	463,500

Shareholders equity	59,564	53,560	44,889	37,096	48,498
Average shares outstanding, diluted	4,902	4,901	3,945	2,953	2,940
Capital Ratios					
Leverage	13.47%	11.75%	10.47%	8.45%	10.54%
Risk-based capital ratios:					
Tier 1 capital	18.67%	16.94%	14.07%	11.24%	12.91%
Total capital	19.93%	18.21%	15.34%	12.51%	14.18%

(1) The efficiency ratio is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under generally accepted accounting principles, or GAAP. See Non-GAAP Financial Measures included in Item 7 of this Form 10-K.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis of the financial condition and results of operations of the Company for the years ended December 31, 2014, 2013 and 2012 should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements included in Item 8 of this Form 10-K.

Executive Overview

The Company

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

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

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

Products, Services, Customers and Locations

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

The Bank provides loan, deposit, wealth management and other products and services in the 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 wealth management division offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement, 401(k) and benefit plans. In addition, the division offers financial planning and brokerage services to individuals throughout the Bank s market area.

The Bank launched a new mortgage division named First Mortgage during the second quarter of 2014. The mortgage division began originating residential mortgage loans to customers in the third quarter of 2014. The majority of loans originated in future periods through this division are expected to be sold to investors in the secondary market. First Mortgage offers mortgage services to customers throughout the Shenandoah Valley of Virginia.

The Bank s products and services are provided through 10 branch offices, 1 customer service center, 2 loan production offices, 25 ATMs and its website, www.fbvirginia.com. Upon the completion of a pending branch acquisition scheduled to close in April 2015, the Bank expects to add four branch offices in the Shenandoah Valley region of Virginia located in Woodstock, Staunton, Waynesboro and Elkton, and two branch offices in central Virginia located in Farmville and Dillwyn. After the transaction closes, the Bank expects to operate a total of 16 branch offices with approximately $750 million in total assets. The loan production offices were opened during 2014 and are located in Staunton and Harrisonburg, Virginia. 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, and wealth management personnel to be readily available to serve customers throughout the Bank s market area. For the location of each of these Financial Centers, see Item 2 of this Form 10-K.

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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 70% and 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 deposits, fee income from wealth management services and ATM and check card fees.

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by factors that include net charge-offs, asset quality, economic conditions and loan growth. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company s control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the year ended December 31, 2014 was salaries and employee benefits, comprising 56% of noninterest expenses, followed by occupancy and equipment expense, comprising 13% of expenses.

Financial Performance

For the year ended December 31, 2014, net income totaled $7.6 million, compared to $9.9 million in 2013. The prior year net income included a $4.8 million favorable impact to the income tax provision from elimination of the valuation allowance on net deferred tax assets. After the effective dividend on preferred stock, net income available to common shareholders was $6.5 million, or $1.32 per basic and diluted share compared to $9.0 million, or $1.83 per basic and diluted share, for the same period in 2013. Return on average assets was 1.45% and return on average equity was 13.49% for the year ended December 31, 2014, compared to 1.85% and 21.87%, respectively, for the year ended December 31, 2013.

Net interest income increased 1%, or $173 thousand to $18.6 million for the year ended December 31, 2014, compared to $18.4 million for the prior year. The net interest margin was 3.86% compared to 3.72% for the same period in 2013. Noninterest income increased $513 thousand, or 7%, to $7.4 million compared to $6.9 million for 2013. Noninterest expense decreased 9.5%, or $2.0 million to $18.8 million for the year ended December 31, 2014 compared to $20.8 million for 2013.

Income before income taxes totaled $11.1 million and $5.1 million for the years ended December 31, 2014 and 2013, respectively. There were significant variances in certain income statement categories when comparing the two periods that may, or may not occur in future periods. These positive and (negative) variances are summarized as follows:

- $3.4 million for the recovery of loan losses;
- $1.3 million for other real estate owned expense;
- $696 thousand for net gains on sale of securities;

($606) thousand for other operating income that included a $543 gain from termination of post-retirement benefits in 2013;

$599 thousand for net losses on disposal of premises and equipment;

$430 thousand for FDIC assessment expense; and

$263 thousand for loss on lease termination.

Income before income taxes, excluding these income statement categories, was unchanged at $6.8 million for the years ended December 31, 2014 and 2013.

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Non-GAAP Financial Measures

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

	Efficiency Ratio	
	2014	2013
Noninterest expense	$ 18,785	$ 20,750
Add/(Subtract): other real estate owned income/(expense), net	213	(1,115)
Subtract: losses on disposal of premises and equipment, net	(2)	(601)
Subtract: loss on land lease termination		(263)
	$ 18,996	$ 18,771
Tax-equivalent net interest income	$ 18,913	$ 18,688
Noninterest income	7,444	6,931
Subtract: securities gains, net	(696)	
Subtract: gain on termination of postretirement benefit obligation		(543)
	$ 25,661	$ 25,076
Efficiency ratio	74.03%	74.86%

This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for each of 2014 and 2013 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 (in thousands).

	Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income	
	2014	2013
GAAP measures:		
Interest income loans	$ 17,777	$ 18,844
Interest income investments and other	2,622	2,313
Interest expense deposits	(1,442)	(2,368)
Interest expense other borrowings	(115)	(119)
Interest expense trust preferred capital notes	(218)	(222)
Interest expense other	(3)	
Total net interest income	$ 18,621	$ 18,448
Non-GAAP measures:		
Tax benefit realized on non-taxable interest income loans	$ 108	$ 82
Tax benefit realized on non-taxable interest income municipal securities	184	158
Total tax benefit realized on non-taxable interest income	$ 292	$ 240
Total tax-equivalent net interest income	$ 18,913	$ 18,688

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.

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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 Bank 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 in this Form 10-K.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management s periodic review of the collectability of the loans in light of historical experience, including 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 Company performs regular credit reviews of the loan portfolio to review credit quality and adherence to underwriting standards. The credit reviews consist of reviews by its internal credit administration department and reviews performed by an independent third party. Upon origination, each loan is assigned a risk rating ranging from one to nine, with loans closer to one having less risk. This risk rating scale is our primary credit quality indicator. The Company has various committees that review and ensure that the allowance for loans losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio.

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

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

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

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

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

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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 is ordered if a current one is not on file. Appraisals are performed by independent third-party appraisers with relevant industry experience. Adjustments to the appraised value may be made based on recent sales of like properties or general market conditions among other considerations.

The general component covers loans that are not considered impaired and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is calculated by loan type and uses an average loss rate during the preceding twelve quarters. The qualitative factors are assigned by management based on delinquencies and asset quality, national and local economic trends, effects of the changes in the value of underlying collateral, trends in volume and nature of loans, effects of changes in the 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 type. The general allowance estimates 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. For further information regarding the allowance for loan losses see Notes 1 and 4 to the Consolidated Financial Statements.

Other Real Estate Owned (OREO)

Other real estate owned (OREO) consists of properties obtained through a foreclosure proceeding or through an in-substance foreclosure in satisfaction of loans and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is reported at the lower of cost or fair value less costs to sell, determined on the basis of current appraisals, comparable sales, and other estimates of fair value obtained principally from independent sources, adjusted for estimated selling costs. Management also considers other factors or recent developments, such as changes in absorption rates or market conditions from the time of valuation and anticipated sales values considering management s plans for disposition, which could result in adjustments to the collateral value estimates indicated in the appraisals. Significant judgments and complex estimates are required in estimating the fair value of other real estate, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. In response to market conditions and other economic factors, management may utilize liquidation sales as part of its distressed asset disposition strategy. As a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other real estate. Management reviews the value of other real estate each quarter and adjusts the values as appropriate. Revenue and expenses from operations and changes in the valuation allowance are included in other real estate owned expenses.

Lending Policies

General

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

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

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As part of the ongoing 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 in order to ensure standards of quality are met. The Company also obtains an independent review of loans within the portfolio on an annual basis to analyze loan risk ratings and validate specific reserves on impaired loans.

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are disclosed but not reflected in its financial statements, including commitments to extend credit. At December 31, 2014, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled $70.9 million.

Construction and Land Development Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated based on the completion of construction. Thus, there is risk associated with failure to complete construction and potential cost overruns. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, typically requires personal guarantees from the borrower s principal owners, and typically monitors the progress of the construction project during the draw period.

1-4 Family Residential Real Estate Lending

1-4 family 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 payments from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank s underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. The valuation of residential collateral is generally provided by independent fee appraisers who have been approved by the Board Loan Committee. In addition to originating fixed rate mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank originates balloon and other mortgage loans for the portfolio. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

Commercial Real Estate Lending

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

Commercial and Industrial Lending

Commercial and industrial 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

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be appraised with as much reliability as residential real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower s principal owners and monitors the financial condition of its business borrowers.

Consumer Lending

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

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

Results of Operations

General

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

Net Interest Income

Net interest income totaled $18.6 million for the year ended December 31, 2014, which was a 1% increase when compared to $18.5 million for the same period in 2013. The net interest margin increased to 3.86% from 3.72% and average earning assets were $12.3 million lower when comparing the periods. The impact of the higher net interest margin on net interest income was partially offset by the impact of lower interest-earning assets. Interest-earning asset yields decreased 4 basis points while the cost of funds, including noninterest-bearing deposits, decreased 18 basis points. Interest-earning asset yields decreased from lower yields earned on loans, as well as higher balances of securities and lower balances of loans, when comparing to 2013. Although interest-earning asset yields fell during the period, decreases in the cost of funds exceeded the decrease in the yields on interest-earning assets, which resulted in a higher net interest margin for 2014 compared to the prior year.

The net interest margin was 3.86% in 2014, 3.72% in 2013 and 3.89% in 2012. Tax-equivalent interest income as a percent of average earning assets was 4.22% in 2014, 4.26% in 2013 and 4.72% in 2012. Interest expense as a percent of average earning assets was 0.36% in 2014, 0.54% in 2013 and 0.83% in 2012. The interest rate spread was 3.73% in 2014, 3.57% in 2013 and 3.68% in 2012.

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The following table provides information on average interest-earning assets and interest-bearing liabilities for the years ended December 31, 2014, 2013 and 2012, as well as amounts and rates of tax equivalent interest earned and interest paid (dollars in thousands). The volume and rate analysis table analyzes the changes in net interest income for the periods broken down by their rate and volume components (in thousands).

Average Balances, Income and Expense, Yields and Rates (Taxable Equivalent Basis)

	Years Ending December 31,								
	2014			2013			2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets									
Interest-bearing deposits in other banks	$ 16,718	$ 38	0.22%	$ 25,091	$ 61	0.24%	$ 15,118	$ 30	0.20%
Securities:									
Taxable	94,689	2,144	2.26%	91,290	1,870	2.05%	81,641	1,924	2.36%
Tax-exempt (1)	11,963	542	4.53%	7,949	465	5.85%	8,702	496	5.70%
Restricted	1,667	82	4.94%	1,843	75	4.07%	2,373	77	3.25%
Total securities	108,319	2,768	2.56%	101,082	2,410	2.38%	92,716	2,497	2.69%
Loans: (2)									
Taxable	358,259	17,568	4.90%	371,317	18,683	5.03%	385,548	21,005	5.45%
Tax-exempt (1)	7,176	317	4.41%	5,244	243	4.64%	1,348	86	6.39%
Total loans	365,435	17,885	4.89%	376,561	18,926	5.03%	386,896	21,091	5.45%
Federal funds sold				2		0.48%	6,165	12	0.19%
Total earning assets	490,472	20,691	4.22%	502,736	21,397	4.26%	500,895	23,630	4.72%
Less: allowance for loan losses	(10,208)			(13,091)			(13,944)		
Total nonearning assets	44,764			44,079			40,305		
Total assets	$ 525,028			$ 533,724			$ 527,256		
Liabilities and Shareholders Equity									
Interest-bearing deposits:									
Checking	$ 112,972	$ 172	0.15%	$ 111,341	$ 289	0.26%	$ 89,778	$ 549	0.61%
Money market accounts	19,155	21	0.11%	16,581	21	0.13%	21,333	67	0.31%
Savings accounts	101,793	89	0.09%	99,670	150	0.15%	96,187	448	0.47%

Certificates of deposit:									
Less than $100	62,623	540	0.86%	77,399	922	1.19%	87,469	1,316	1.50%
Greater than $100	47,963	592	1.23%	61,579	923	1.50%	71,504	1,238	1.73%
Brokered deposits	4,756	28	0.59%	9,604	63	0.65%	11,478	89	0.77%
Total interest-bearing deposits	349,262	1,442	0.41%	376,174	2,368	0.63%	377,749	3,707	0.98%
Federal funds purchased	357	3	0.87%	2		0.70%	3		0.67%
Trust preferred capital notes	9,279	218	2.35%	9,279	222	2.39%	9,279	238	2.56%
Other borrowings	5,891	115	1.95%	6,064	119	1.96%	12,208	222	1.82%
Total interest-bearing liabilities	364,789	1,778	0.49%	391,519	2,709	0.69%	399,239	4,167	1.04%
Noninterest-bearing liabilities									
Demand deposits	101,209			92,339			81,832		
Other liabilities	2,451			4,727			4,984		
Total liabilities	468,449			488,585			486,055		
Shareholders equity	56,579			45,139			41,201		
Total liabilities and shareholders equity	$ 525,028			$ 533,724			$ 527,256		
Net interest income		$ 18,913			$ 18,688			$ 19,463	
Interest rate spread			3.73%			3.57%			3.68%
Cost of funds			0.38%			0.56%			0.87%
Interest expense as a percent of average earning assets			0.36%			0.54%			0.83%
Net interest margin			3.86%			3.72%			3.89%

(1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was $292 thousand, $240 thousand and $198 thousand for 2014, 2013 and 2012, respectively.

(2) Loans placed on a non-accrual status are reflected in the balances.

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	Volume and Rate Years Ending December 31, 2014			2013		
	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense
Interest-bearing deposits in other banks	$ (19)	$ (5)	$ (24)	$ 24	$ 7	$ 31
Loans, taxable	(642)	(472)	(1,114)	(752)	(1,570)	(2,322)
Loans, tax-exempt	84	(11)	73	174	(17)	157
Securities, taxable	73	201	274	438	(492)	(54)
Securities, tax-exempt	140	(62)	78	(11)	(20)	(31)
Securities, restricted	(6)	13	7	15	(17)	(2)
Federal funds sold				23	(35)	(12)
Total earning assets	$ (370)	$ (336)	$ (706)	$ (89)	$ (2,144)	$ (2,233)
Checking	$ 4	$ (121)	$ (117)	$ 187	$ (447)	$ (260)
Money market accounts	8	(8)		(13)	(33)	(46)
Savings accounts	3	(64)	(61)	17	(315)	(298)
Certificates of deposits:						
Less than $100	(157)	(227)	(384)	(141)	(253)	(394)
Greater than $100	(182)	(148)	(330)	(161)	(154)	(315)
Brokered deposits	(29)	(5)	(34)	(13)	(13)	(26)
Federal funds purchased	3		3			
Trust preferred capital notes		(4)	(4)		(16)	(16)
Other borrowings	(3)	(1)	(4)	(122)	19	(103)
Total interest-bearing liabilities	$ (353)	$ (578)	$ (931)	$ (246)	$ (1,212)	$ (1,458)
Change in net interest income	$ (17)	$ 242	$ 225	$ 157	$ (932)	$ (775)

Provision for (Recovery of) Loan Losses

The provision for (or recovery of) loan losses represents management s analysis of the existing loan portfolio and related credit risks. The provision for (or recovery of) loan losses is based upon management s estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio.

The recovery of loan losses totaled $3.9 million for 2014, which resulted in a total allowance for loan losses of $6.7 million or 1.77% of total loans at December 31, 2014. This compared to a recovery of loan losses of $425 thousand for 2013 and an allowance for loan losses of $10.6 million, or 2.98% of total loans, at the prior year end.

The recovery of loan losses recorded in 2014 resulted primarily from a $4.4 million decrease in the general reserve component of the allowance for loan losses, when comparing the allowance for loan losses at December 31, 2014 and 2013. The $4.4 million decrease was driven primarily by lower historical net charge-offs that accounted for $4.2 million of the decrease, along with changes in qualitative adjustment factors that accounted for $241 thousand of the decrease. The impact on the general reserve from historical net charge-offs was attributable to the significant decrease, or improvement, in net charge-offs experienced during the three year period ended December 31, 2014, compared to the three year period ended December 31, 2013. The primary reason for the improvement was a significant amount of net charge-offs experienced during 2011 were no longer included in the three year loss history that determines the required general reserve component of the allowance for loan loss estimate at December 31, 2014. The Company has consistently applied its allowance for loan loss methodology and regularly reviews the three year historical charge-off look back period to ensure it is indicative of the risk that remains in the loan portfolio. As evidenced in the changes in the allowance for loan losses table appearing in the Asset Quality section, loan losses experienced in 2011 were not repeated in 2012, 2013 or 2014 and Management has no reason to believe that net charge-offs of that magnitude will be experienced in 2015. The $4.4 million decrease in the general reserve component was partially offset by a $528 thousand increase in the specific reserve component.

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For the year ended December 31, 2013, the recovery of loan losses totaled $425 thousand compared to the provision for loan losses of $3.6 million for the year ended December 31, 2012. The decrease in the provision for loan losses during 2013 was attributable to two large loan recoveries, an improvement in historical loss experience and lower specific reserves on impaired loans when compared to the year ended December 31, 2012.

Noninterest Income

Noninterest income increased 7% to $7.4 million for the year ended December 31, 2014 from $6.9 million for the same period in 2013. Noninterest income, excluding $696 thousand of net gains on sale of securities in 2014 and a $543 thousand one-time gain on termination of a post-retirement benefit in 2013, increased 6% to $6.7 million compared to $6.4 million for the same period one year ago. Noninterest income was positively impacted by higher levels of service charges on deposits, which increased 17% or $368 thousand over the prior year, as well as wealth management fees, which increased 13% or $219 thousand over the prior year. Revenue from service charges on deposit accounts increased primarily from increased checking account activity and the increase in wealth management fees resulted primarily from higher balances of assets under management during 2014 compared to the same period one year ago.

In 2013, noninterest income decreased 3% to $6.9 million from $7.2 million for 2013, primarily from gains on sales of securities in 2012.

Noninterest Expense

Noninterest expense decreased 9% or $2.0 million to $18.8 million for the year ended December 31, 2014, compared to $20.8 million for the same period in 2013. Expenses related to other real estate owned decreased $1.3 million, FDIC assessment expenses decreased $430 thousand, net gains on the sale of property and equipment decreased $599 thousand, and the loss on lease termination decreased $263 thousand, compared to the same period one year ago. Decreases in expenses related to other real estate owned resulted primarily from lower write-downs in the carrying value of OREO property when comparing the periods. FDIC assessments were also lower in 2014 than in the prior year due to lower assessment levels. During 2014, the Company did not terminate leases resulting in losses on lease termination or net losses on disposal of property and equipment, compared to 2013 which included a loss on lease termination and net losses on disposal of property and equipment that totaled $263 thousand and $601 thousand, respectively. These prior year expenses were a result of the Company s decision to terminate a land lease during that period.

The decreases in these noninterest expense categories were partially offset by increases in other operating expenses of 14% or $232 thousand, increases of 38% or $142 thousand in data processing expenses, and increases of 47% or $131 thousand in bank franchise tax. Other operating expenses increased primarily from a new feature provided to checking account customers, and also additional loan expenses associated with the growth of the loan portfolio. Increases in data processing expenses were primarily attributable to the shift in customer behavior from traditional to electronic services. Bank franchise tax increased because of higher levels of capital when comparing the periods.

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 years ended December 31, 2014 and 2013. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income and from the reversal of the full valuation allowance on the Company s net deferred tax asset. As of December 31, 2013, the Company had reversed the full valuation allowance on its net deferred tax assets (DTAs). The realization of DTAs is assessed and a valuation allowance is recorded if it is more likely than not that all or a portion of the deferred tax asset will not be realized. More likely than not is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. In assessing the need for a valuation allowance, the Company considered all available evidence about the realization of DTAs, both positive and negative, that could be objectively verified.

Positive evidence considered included (1) a return to trailing three years of cumulative pre-tax income in 2013, (2) the Company s recent history of quarterly pre-tax earnings, (3) expectations for sustained profitability with sufficient taxable income to fully utilize the remaining net deferred tax benefits and (4) significant reductions in the level of non-performing assets since their peak during 2011, which was the primary source of the losses generated in 2010 and 2011.

Negative evidence considered was (1) the uncertainty about the potential impact on future earnings from nonperforming assets along with (2) a pre-tax loss reported by the Company during one quarterly period over the previous two years. As the

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number of consecutive periods of profitability increased and the level of profits are indicative of on-going results, the weight of cumulative losses as negative evidence decreased. A reduction in the weight given to such losses is further validated given that the source of the losses was due to an elevated level of problem assets and related credit costs, which have since been significantly reduced.

After weighing both the positive and negative evidence, management determined that a valuation allowance on the net deferred tax asset was no longer warranted as of December 31, 2013. No conditions existed during 2014 that would have caused the Company to re-evaluate the need for a valuation allowance on net deferred tax assets. For a more detailed discussion of the Company s tax calculation, see Note 10 to the consolidated financial statements, included in Item 8 of this Form 10-K.

Financial Condition

General

Total assets were $518.2 million at December 31, 2014 compared to $522.9 million at December 31, 2013. The Company s wealth management group had assets under management of $313.3 million at December 31, 2014 compared to $284.7 million at December 31, 2013. Assets managed by the wealth management group are not reflected on the Company s balance sheet.

Loans

The Bank is an active lender with a loan portfolio that includes commercial and residential real estate loans, commercial loans, consumer loans, construction and land development loans and home equity loans. The Bank s lending activity is concentrated on individuals, small and medium-sized businesses and local governmental entities primarily in its market area. As a provider of community-oriented financial services, the Bank does not attempt to geographically diversify its loan portfolio by undertaking significant lending activity outside its market area.

Gross loan balances increased 6% or $21.3 million to $378.4 million at December 31, 2014, compared to $357.1 million at December 31, 2013. The increase in loan balances was primarily the result of a slight improvement in loan demand, efforts of employees, and less pay-offs on loans, including classified loans, compared to prior years.

The Bank s loan portfolio is summarized in the table below for the periods indicated (dollars in thousands).

Loan Portfolio
At December 31,

	2014		2013		2012		2011		2010	
Commercial, financial, and agricultural	$ 21,166	5.59%	$ 22,803	6.39%	$ 23,071	6.01%	$ 29,446	7.50%	$ 39,796	9.15%
Real estate construction	29,475	7.79%	34,060	9.54%	43,524	11.35%	48,363	12.33%	52,591	12.09%
Real estate mortgage:										

Residential (1-4 family)	163,727	43.27%	141,961	39.76%	134,964	35.18%	122,339	31.17%	121,506	27.93%
Secured by farmland	1,129	0.30%	1,264	0.35%	5,795	1.51%	6,161	1.57%	6,207	1.43%
Other real estate loans	150,673	39.82%	144,704	40.52%	168,425	43.91%	174,980	44.59%	201,164	46.24%
Consumer	5,070	1.34%	5,214	1.46%	7,144	1.86%	10,085	2.57%	12,879	2.96%
All other loans	7,170	1.89%	7,087	1.98%	671	0.18%	1,066	0.27%	887	0.20%
Total loans	$ 378,410	100%	$ 357,093	100%	$ 383,594	100%	$ 392,440	100%	$ 435,030	100%
Less: allowance for loan losses	6,718		10,644		13,075		12,937		16,036	
Loans, net of allowance for loan losses	$ 371,692		$ 346,449		$ 370,519		$ 379,503		$ 418,994	

There was no category of loans that exceeded 10% of outstanding loans at December 31, 2014 that were not disclosed in the above table.

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The following table sets forth the maturities of the loan portfolio at December 31, 2014 (in thousands):

	Remaining Maturities of Selected Loans At December 31, 2014			
	Less than One Year	One to Five Years	Greater than Five Years	Total
Commercial, financial, and agricultural	$ 9,213	$ 10,452	$ 1,501	$ 21,166
Real estate construction and land development	17,922	10,703	850	29,475
Real estate mortgage:				
Residential (1-4 family)	23,861	74,998	64,868	163,727
Other real estate loans	19,786	83,969	48,047	151,802
Consumer and other loans	1,294	10,784	162	12,240
Total loans	$ 72,076	$ 190,906	$ 115,428	$ 378,410

For maturities over one year:	
Fixed rates	$ 237,111
Variable rates	69,223
	$ 306,334

Asset Quality

Management classifies non-performing assets as non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is recorded at the lower of cost or fair value, less estimated selling costs, and is marketed by the Bank through brokerage channels. The Bank s OREO, net of valuation allowance, totaled $1.9 million at December 31, 2014 and $3.0 million at December 31, 2013. Non-performing assets were $9.9 million and $14.7 million at December 31, 2014 and 2013, representing 1.91% and 2.81% of total assets, respectively. Non-performing assets included $8.0 million in non-accrual loans and $1.9 million in OREO, net of the valuation allowance, at December 31, 2014. This compares to $11.7 million in non-accrual loans and $3.0 million in OREO, net of the valuation allowance at December 31, 2013.

The levels of non-performing assets at December 31, 2014 and December 31, 2013 were primarily attributable to the impact of local economic conditions in recent years 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 real estate development and commercial and residential rental real estate. At December 31, 2014, 41% related to commercial real estate loans, 34% of non-performing assets related to construction and land development loans, 14% related to residential real estate loans, 7% related to multi-family residential loans, 3% related to properties originally acquired for branch expansion no longer intended to be used for that purpose and 1% related to commercial and industrial loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower s ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. Other potential problem loans totaled $15.8 million and $23.5 million at December 31, 2014 and December 31, 2013, respectively. The amount of other potential problem loans in future periods may be dependent on economic conditions and other factors influencing our customers ability to meet their debt requirements.

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 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 $6.7 million at December 31, 2014 and $10.6 million at December 31, 2013, representing 1.77% and 2.98% of total loans, respectively. The primary reason for the decrease in the allowance for loan losses was a significant amount of net charge-offs experienced during 2011 were no longer included in the three year loss history that determines the required general reserve component of the allowance for loan loss estimate at December 31, 2014. After analyzing the composition of the loan portfolio, related credit risks, and improvements in asset quality during recent years, the Company determined that the three year loss period and the qualitative adjustment factors that established the general reserve component of the allowance for loan losses were appropriate at December 31, 2014. For further discussion regarding the decrease in the allowance for loan losses, see Provision for (Recovery of) Loan Losses above.

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Impaired loans totaled $13.9 million at December 31, 2014, compared to $21.7 million at December 31, 2013. The related allowance for loan losses provided for these loans totaled $1.9 million and $1.4 million at December 31, 2014 and 2013. The average recorded investment in impaired loans during 2014 and 2013 was $19.2 million and $16.0 million, respectively. Included in the impaired loans total are loans classified as troubled debt restructurings (TDRs) totaling $1.9 million at December 31, 2014 and 2013. 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 December 31, 2014, $790 thousand of these TDRs were performing under the restructured terms and were not considered non-performing assets.

Management believes, based upon its review and analysis, that the Bank has sufficient reserves to cover losses inherent within the loan portfolio. For each period presented, the provision for loan losses charged to expense was based on management s judgment after taking into consideration all factors connected with the collectability of the existing portfolio. Management considers economic conditions, historical loss factors, past due percentages, internally generated loan quality reports and other relevant factors when evaluating the loan portfolio. There can be no assurance, however, that an additional provision for loan losses will not be required in the future, including as a result of changes in the qualitative factors 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. The following table shows a detail of loans charged-off, recovered and the changes in the allowance for loan losses (dollars in thousands).

	Allowance for Loan Losses At December 31,				
	2014	2013	2012	2011	2010
Balance, beginning of period	$ 10,644	$ 13,075	$ 12,937	$ 16,036	$ 7,106
Loans charged-off:					
Commercial, financial and agricultural	43	37	261	348	387
Real estate-construction and land development	91	2,962	431	2,983	1,225
Real estate-mortgage					
Residential (1-4 family)	272	260	761	4,639	132
Non-farm, non-residential	203	1,070	2,154	7,551	978
Secured by farmland					
Consumer	318	163	186	268	340
All other loans					
Total loans charged off	$ 927	$ 4,492	$ 3,793	$ 15,789	$ 3,062
Recoveries:					
Commercial, financial and agricultural	$ 18	$ 179	$ 35	$ 3	$ 1
Real estate-construction and land development	80		1	50	
Real estate-mortgage					
Residential (1-4 family)	15	823	68	6	8
Non-farm, non-residential	509	1,304	64		
Secured by farmland					
Consumer	229	180	208	251	252

All other loans

Total recoveries	$ 851	$ 2,486	$ 376	$ 310	$ 261
Net charge-offs	$ 76	$ 2,006	$ 3,417	$ 15,479	$ 2,801
Provision for (recovery of) loan losses	(3,850)	(425)	3,555	12,380	11,731
Balance, end of period	$ 6,718	$ 10,644	$ 13,075	$ 12,937	$ 16,036
Ratio of net charge-offs during the period to average loans outstanding during the period	0.02%	0.53%	0.88%	3.70%	0.63%

The following table shows the balance and percentage of the Bank s allowance for loan losses allocated to each major category of loans (dollars in thousands).

Allocation of Allowance for Loan Losses

At December 31,

	2014		2013		2012		2011		2010	
Commercial, financial and agricultural	$ 310	4.61%	$ 442	6.39%	$ 608	6.01%	$ 963	7.50%	$ 858	9.15%
Real estate-construction and land development	1,403	20.89%	2,710	9.54%	2,481	11.35%	2,843	12.33%	4,050	12.09%
Real estate-mortgage	4,862	72.37%	7,393	80.63%	9,875	80.60%	8,958	77.33%	10,868	75.60%
Consumer	67	1.00%	24	1.46%	101	1.86%	157	2.57%	248	2.96%
All other	76	1.13%	75	1.98%	10	0.18%	15	0.27%	12	0.20%
	$ 6,718	100.0%	$ 10,644	100.0%	$ 13,075	100.0%	$ 12,937	100.0%	$ 16,036	100.0%

The following table provides information on the Bank s non-performing assets at the dates indicated (dollars in thousands).

Non-performing Assets

At December 31,

	2014	2013	2012	2011	2010
Non-accrual loans	$ 8,000	$ 11,678	$ 8,393	$ 11,841	$ 10,817
Other real estate owned	1,888	3,030	5,590	6,374	3,961
Total non-performing assets	$ 9,888	$ 14,708	$ 13,983	$ 18,215	$ 14,778
Loans past due 90 days accruing interest		49	228	459	598
Total non-performing assets and past due loans	$ 9,888	$ 14,757	$ 14,211	$ 18,674	$ 15,376
Troubled debt restructurings	$ 1,918	$ 1,941	$ 6,326	$ 11,385	$ 14,428
Allowance for loan losses to period end loans	1.77%	2.98%	3.41%	3.30%	3.69%
Non-performing assets to period end loans	2.61%	4.12%	3.65%	4.64%	3.40%

Securities

Securities at December 31, 2014 totaled $83.2 million, a decrease of $20.0 million or 19%, from $103.3 million at the end of 2013. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. The decrease in the securities portfolio was related to higher loan demand in the Company s market area during 2014 compared to recent years. As of December 31, 2014, neither the Company nor the Bank held any derivative financial instruments in their respective investment security portfolios. Gross unrealized gains in the securities portfolio totaled $704 thousand and $1.0 million at December 31, 2014 and 2013, respectively. Gross unrealized losses totaled $906 thousand and $2.7 million at December 31, 2014 and 2013, respectively. Investments in an unrealized loss position were considered temporarily impaired at December 31, 2014 and 2013.

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The following table summarizes the fair value of the Company s securities portfolio on the dates indicated (in thousands).

Securities Portfolio
At December 31,

	2014	2013	2012
Securities, available for sale			
U.S. agency and mortgage-backed securities	$ 67,029	$ 84,897	$ 73,218
Obligations of state and political subdivisions	16,257	18,399	16,235
Other securities	6	5	3
Total securities	$ 83,292	$ 103,301	$ 89,456

The following table shows the maturities of debt and equity securities at amortized cost and market value at December 31, 2014 and approximate weighted average yields of such securities (dollars in thousands). Yields on state and political subdivision securities are shown on a tax equivalent basis, assuming a 34% federal income tax rate. The Company attempts to maintain diversity in its portfolio and maintain credit quality and re-pricing terms that are consistent with its asset/liability management and investment practices and policies. For further information on securities available for sale, see Note 2 to the consolidated financial statements, included in Item 8 of this Form 10-K.

Securities Portfolio Maturity Distribution/Yield Analysis
At December 31, 2014

	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years and Equity Securities	Total
Available for sale securities:					
U.S. agency and mortgage-backed securities					
Amortized cost	$	$ 4,096	$ 11,888	$ 51,478	$ 67,462
Market value	$	$ 4,041	$ 11,773	$ 51,215	$ 67,029
Weighted average yield	0.00%	1.36%	1.71%	1.96%	1.88%
Obligations of state and political subdivisions					
Amortized cost	$	$ 2,859	$ 5,846	$ 7,326	$ 16,031
Market value	$	$ 2,904	$ 5,930	$ 7,423	$ 16,257
Weighted average yield	0.00%	3.87%	3.34%	3.80%	3.64%
Equity securities					
Amortized cost	$	$	$	$ 1	$ 1
Market value	$	$	$	$ 6	$ 6
Weighted average yield	0.00%	0.00%	0.00%	1.65%	1.65%
Total portfolio					

Amortized cost	$	$ 6,955	$ 17,734	$ 58,805	$ 83,494
Market value	$	$ 6,945	$ 17,703	$ 58,644	$ 83,292
Weighted average yield [1]	0.00%	2.39%	2.25%	2.19%	2.22%

[1] Yields on tax-exempt securities have been calculated on a tax-equivalent basis.

The above table was prepared using the contractual maturities for all securities with the exception of mortgage-backed securities (MBS) and collateralized mortgage obligations (CMO). Both MBS and CMO securities were recorded using the yield book prepayment model that incorporates four causes of prepayments including home sales, refinancing, defaults, and curtailments/full payoffs.

Deposits

Deposits at December 31, 2014 totaled $444.3 million, a decrease of $6.4 million, from $450.7 million at December 31, 2013. Non-interest bearing demand deposits increased $12.1 million or 13% to $105.0 million during the year ended December 31, 2014 from $92.9 million at December 31, 2013. Savings and interest-bearing demand deposits increased $3.6 million or 2% to $237.6 million at December 31, 2014 compared to $234.1 million at December 31, 2013. Time deposits, which include brokered deposits, decreased $22.0 million or 18% during the year ended December 31, 2014 to $101.7 million compared to $123.8 million at December 31, 2013.

The following tables include a summary of average deposits and average rates paid and maturities of CD s greater than $100,000 (dollars in thousands).

	Average Deposits and Rates Paid Year Ended December 31,					
	2014		2013		2012	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing deposits	$ 101,209		$ 92,339		$ 81,832	
Interest-bearing deposits:						
Interest checking	$ 112,972	0.15%	$ 111,341	0.26%	$ 89,778	0.61%
Money market	19,155	0.11%	16,581	0.13%	21,333	0.31%
Savings	101,793	0.09%	99,670	0.15%	96,187	0.47%
Time deposits:						
Less than $100	62,623	0.86%	77,399	1.19%	87,469	1.50%
Greater than $100	47,963	1.23%	61,579	1.50%	71,504	1.73%
Brokered deposits	4,756	0.59%	9,604	0.65%	11,478	0.77%
Total interest-bearing deposits	$ 349,262	0.41%	$ 376,174	0.63%	$ 377,749	0.98%
Total deposits	$ 450,471		$ 468,513		$ 459,581	

	Maturities of CD s Greater than $100,000				
	Less than Three Months	Three to Six Months	Six to Twelve Months	Greater than One Year	Total
At December 31, 2014	$ 9,257	$ 6,951	$ 6,480	$ 24,389	$ 47,077

The table above includes brokered deposits greater than $100 thousand.

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 part of the Bank s liquidity risk management, stress tests and cash flow modeling are performed quarterly.

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.

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At December 31, 2014, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled $96.9 million. At December 31, 2014, 19% or $72.1 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled $88.7 million at December 31, 2014, which included $42.9 million available from Federal Home Loan Bank of Atlanta (FHLB), $41.9 million of unsecured federal funds lines of credit with other correspondent banks and $3.9 million available through the Federal Reserve Discount Window.

Trust Preferred Capital Notes

See Note 9 to the consolidated financial statements, included in Item 8 of this Form 10-K, for discussion of trust preferred capital notes.

Contractual Obligations

The impact that contractual obligations as of December 31, 2014 are expected to have on liquidity and cash flow in future periods is as follows (in thousands):

	Contractual Obligations				
	Total	Less than one year	1-3 years	3-5 years	More than 5 years
Other borrowings	$ 26	$ 26	$	$	$
Operating leases	160	69	65	26	
Total	$ 186	$ 95	$ 65	$ 26	$

The Company does not have any capital lease obligations or other purchase or long-term obligations.

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.

At December 31, 2014 and 2013, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2014	2013
	$ 60,019	$ 59,115

Commitments to extend credit and unfunded commitments under lines of credit		
Stand-by letters of credit	9,763	7,610

Commitments to extend credit 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 usually do not contain a specified maturity date and may or may not be drawn upon to the total extent to which the Bank is committed.

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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. 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 December 31, 2014, the Bank had $1.1 million in locked-rate commitments to originate mortgage loans. 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.

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.

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 intangible items. Under present regulations, 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. The Company had a ratio of risk-weighted assets to total capital of 19.93% at December 31, 2014 and a ratio of risk-weighted assets to Tier 1 capital of 18.67%. Both of these exceed both the minimum capital requirement and the minimum to be well capitalized under prompt corrective action provisions adopted by the federal regulatory agencies.

The following table summarizes the Company s Tier 1 capital, Tier 2 capital, risk-weighted assets and capital ratios at December 31, 2014, 2013 and 2012 (dollars in thousands).

Analysis of Capital

	At December 31,		
	2014	2013	2012
Tier 1 capital:			
Preferred stock	$ 14,595	$ 14,564	$ 14,409
Common stock	6,131	6,127	6,127
Surplus	6,835	6,813	6,813
Retained earnings	33,557	27,360	18,399
Trust preferred capital notes	9,279	9,279	9,279
Disallowed deferred tax asset		(2,235)	
Intangible assets	(85)	(108)	(130)
Total Tier 1 Capital	$ 70,312	$ 61,800	$ 54,897
Tier 2 capital:			

Allowance for loan losses	4,733	4,637	4,979
Total Risk-Based Capital	$ 75,045	$ 66,437	$ 59,877
Risk-weighted assets	$ 376,626	$ 364,915	$ 390,254
Capital ratios:			
Total Risk-Based Capital Ratio	19.93%	18.21%	15.34%
Tier 1 Risk-Based Capital Ratio	18.67%	16.94%	14.07%
Tier 1 Capital to Average Assets	13.47%	11.75%	10.47%

Under present regulations, 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 December 31, 2014 and 2013, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital. The Company is current on the interest payments on its trust preferred capital notes.

The Company s Preferred Stock includes Series A Preferred Stock which paid a dividend of 5% per annum until May 14, 2014 and 9% thereafter, and Series B Preferred Stock which pays a dividend of 9% per annum. The Company is current on its dividend payments on each series of preferred stock.

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

Recent Accounting Pronouncements

See Note 1 to the consolidated financial statements, included in Item 8 of this Form 10-K, for discussion of recent accounting pronouncements.

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Quarterly Results

The table below lists the Company s quarterly performance for the years ended December 31, 2014, 2013 and 2012 (in thousands, except per share data).

	2014				
	Fourth	Third	Second	First	Total
Interest and dividend income	$ 5,214	$ 5,181	$ 5,095	$ 4,909	$ 20,399
Interest expense	409	430	456	483	1,778
Net interest income	4,805	4,751	4,639	4,426	18,621
Recovery of loan losses	(3,150)	(100)	(400)	(200)	(3,850)
Net interest income after recovery of loan losses	7,955	4,851	5,039	4,626	22,471
Noninterest income	2,449	1,654	1,725	1,616	7,444
Noninterest expense	4,871	4,753	4,548	4,613	18,785
Income before income taxes	5,533	1,752	2,216	1,629	11,130
Income tax expense	1,837	505	674	483	3,499
Net income	$ 3,696	$ 1,247	$ 1,542	$ 1,146	$ 7,631
Net income available to common shareholders	$ 3,368	$ 918	$ 1,281	$ 926	$ 6,493
Net income per share, basic and diluted	$ 0.68	$ 0.19	$ 0.26	$ 0.19	$ 1.32

	2013				
	Fourth	Third	Second	First	Total
Interest and dividend income	$ 5,093	$ 5,286	$ 5,371	$ 5,407	$ 21,157
Interest expense	544	657	717	791	2,709
Net interest income	4,549	4,629	4,654	4,616	18,448
Provision for (recovery of) loan losses	(2,950)	275	2,500	(250)	(425)
Net interest income after provision for (recovery of) loan losses	7,499	4,354	2,154	4,866	18,873
Noninterest income	1,771	1,625	2,034	1,501	6,931
Noninterest expense	6,232	4,648	4,757	5,113	20,750
Income (loss) before income taxes	3,038	1,331	(569)	1,254	5,054
Income tax expense (benefit)	(4,352)	91	(830)	271	(4,820)
Net income	$ 7,390	$ 1,240	$ 261	$ 983	$ 9,874

Net income available to common shareholders	$ 7,162	$ 1,011	$ 31	$ 757	$ 8,961
Net income per share, basic and diluted	$ 1.46	$ 0.21	$ 0.01	$ 0.15	$ 1.83

	2012				
	Fourth	Third	Second	First	Total
Interest and dividend income	$ 5,573	$ 5,771	$ 5,880	$ 6,208	$ 23,432
Interest expense	919	1,035	1,085	1,128	4,167
Net interest income	4,654	4,736	4,795	5,080	19,265
Provision for loan losses	100	805	650	2,000	3,555
Net interest income after provision for loan losses	4,554	3,931	4,145	3,080	15,710
Noninterest income	1,589	1,609	1,462	2,514	7,174
Noninterest expense	5,124	4,657	4,434	4,904	19,119
Income before income taxes	1,019	883	1,173	690	3,765
Income tax expense	76	195	479	215	965
Net income	943	688	694	475	2,800
Net income available to common shareholders	716	462	467	251	1,896
Net income per share, basic and diluted	$ 0.15	$ 0.09	$ 0.16	$ 0.08	$ 0.48

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Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not required.

Item 8. Financial Statements and Supplementary Data

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To the Shareholders March 27, 2015
First National Corporation
Strasburg, Virginia

MANAGEMENT S REPORT REGARDING THE EFFECTIVENESS OF INTERNAL CONTROLS

OVER FINANCIAL REPORTING

The management of First National Corporation (the Company) is responsible for the preparation, integrity and fair presentation of the financial statements included in the annual report as of December 31, 2014. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management s judgments and estimates concerning the effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining an effective internal control structure over financial reporting. The Company s internal control over financial reporting includes those policies and procedures that pertain to the Company s ability to record, process, summarize and report reliable financial data. The internal control system contains monitoring mechanisms, and appropriate actions are taken to correct identified deficiencies. Management believes that internal controls over financial reporting, which are subject to scrutiny by management and the Company s internal auditor, support the integrity and reliability of the financial statements. Management recognizes that there are inherent limitations in the effectiveness of any internal control system, including the possibility of human error and the circumvention or overriding of internal controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. In addition, because of changes in conditions and circumstances, the effectiveness of internal control over financial reporting may vary over time.

In order to insure that the Company s internal control structure over financial reporting is effective, management assessed these controls as they conformed to accounting principles generally accepted in the United States of America and related call report instructions as of December 31, 2014. This assessment was based on criteria for effective internal control over financial reporting as described in Internal Control Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management believes that the Company maintained effective internal controls over financial reporting as of December 31, 2014. Management s assessment did not determine any material weakness within the Company s internal control structure. The Company s annual report does not include an attestation report of the Company s registered public accounting firm, Yount, Hyde & Barbour. P.C. (YHB), regarding internal control over financial reporting. Management report was not subject to attestation by YHB pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management s report in its annual report.

The 2014 end of year financial statements have been audited by the independent accounting firm of Yount, Hyde & Barbour, P.C. (YHB). Personnel from YHB were given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and Committees thereof.

Management believes that all representations made to the independent auditors were valid and appropriate. The resulting report from YHB accompanies the financial statements.

The Board of Directors of the Company, acting through its Audit Committee (the Committee), is responsible for the oversight of the Company s accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent auditors and approves decisions regarding the appointment or removal of members of the internal audit function. The Committee meets periodically with management, the independent auditors, and the internal auditor to insure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Company in addition to reviewing the Company s financial reports. The independent auditors and the internal auditor have full and unlimited access to the Audit Committee, with or without the presence of the management of the Company, to discuss the adequacy of internal control over financial reporting, and any other matters which they believe should be brought to the attention of the Audit Committee.

/s/ Scott C. Harvard	/s/ M. Shane Bell
Scott C. Harvard	M. Shane Bell
President	Executive Vice President
Chief Executive Officer	Chief Financial Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors

First National Corporation

Strasburg, Virginia

We have audited the accompanying consolidated balance sheets of First National Corporation and subsidiaries as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First National Corporation and subsidiaries as of December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 27, 2015

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FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

December 31, 2014 and 2013

(in thousands, except share and per share data)

	2014	2013
Assets		
Cash and due from banks	$ 6,043	$ 5,767
Interest-bearing deposits in banks	18,802	25,741
Securities available for sale, at fair value	83,292	103,301
Restricted securities, at cost	1,366	1,804
Loans held for sale	328	
Loans, net of allowance for loan losses, 2014, $6,718, 2013, $10,644	371,692	346,449
Other real estate owned, net of valuation allowance, 2014, $375, 2013, $1,665	1,888	3,030
Premises and equipment, net	16,126	16,642
Accrued interest receivable	1,261	1,302
Bank owned life insurance	11,357	10,978
Other assets	6,010	7,876
Total assets	$ 518,165	$ 522,890
Liabilities & Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 104,986	$ 92,901
Savings and interest-bearing demand deposits	237,618	234,054
Time deposits	101,734	123,756
Total deposits	$ 444,338	$ 450,711
Federal funds purchased	52	
Other borrowings	26	6,052
Trust preferred capital notes	9,279	9,279
Accrued interest payable and other liabilities	4,906	3,288
Total liabilities	$ 458,601	$ 469,330
Shareholders Equity		
Preferred stock, $1,000 per share liquidation preference; authorized 1,000,000 shares; 14,595 shares issued and outstanding, net of discount	$ 14,595	$ 14,564

Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2014, 4,904,577 shares, 2013, 4,901,464 shares	6,131	6,127
Surplus	6,835	6,813
Retained earnings	33,557	27,360
Accumulated other comprehensive loss, net	(1,554)	(1,304)
Total shareholders equity	$ 59,564	$ 53,560
Total liabilities and shareholders equity	$ 518,165	$ 522,890

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

Three Years Ended December 31, 2014

(in thousands, except per share data)

	2014	2013	2012
Interest and Dividend Income			
Interest and fees on loans	$ 17,777	$ 18,844	$ 21,062
Interest on federal funds sold			12
Interest on deposits in banks	38	61	30
Interest and dividends on securities available for sale:			
Taxable interest	2,144	1,870	1,924
Tax-exempt interest	358	307	327
Dividends	82	75	77
Total interest and dividend income	$ 20,399	$ 21,157	$ 23,432
Interest Expense			
Interest on deposits	$ 1,442	$ 2,368	$ 3,707
Interest on federal funds purchased	3		
Interest on trust preferred capital notes	218	222	238
Interest on other borrowings	115	119	222
Total interest expense	$ 1,778	$ 2,709	$ 4,167
Net interest income	$ 18,621	$ 18,448	$ 19,265
Provision for (recovery of) loan losses	(3,850)	(425)	3,555
Net interest income after provision for (recovery of) loan losses	$ 22,471	$ 18,873	$ 15,710
Noninterest Income			
Service charges on deposit accounts	$ 2,572	$ 2,204	$ 2,127
ATM and check card fees	1,419	1,425	1,481
Wealth management fees	1,915	1,696	1,450
Fees for other customer services	397	391	390
Income from bank owned life insurance	367	358	14
Net gains on sale of securities available for sale	696		1,285
Net gains on sale of loans	20	193	214
Gain on termination of postretirement benefit		543	

Other operating income	58	121	211
Total noninterest income	$ 7,444	$ 6,931	$ 7,172

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

(Continued)

Three years ended December 31, 2014

(in thousands, except per share data)

	2014	2013	2012
Noninterest Expense			
Salaries and employee benefits	$ 10,586	$ 10,528	$ 9,590
Occupancy	1,211	1,282	1,343
Equipment	1,191	1,208	1,208
Marketing	426	345	430
Stationery and supplies	333	288	308
Legal and professional fees	1,019	975	975
ATM and check card fees	661	668	649
FDIC assessment	454	884	709
Bank franchise tax	410	279	260
Telecommunications expense	300	283	245
Data processing expense	518	376	347
Other real estate owned (income) expense, net	(213)	1,115	1,355
Net (gain) loss on disposal of premises and equipment	2	601	(2)
Loss on lease termination		263	
Other operating expense	1,887	1,655	1,700
Total noninterest expense	$ 18,785	$ 20,750	$ 19,117
Income before income taxes	$ 11,130	$ 5,054	$ 3,765
Income tax provision (benefit)	3,499	(4,820)	965
Net income	$ 7,631	$ 9,874	$ 2,800
Effective dividend and accretion on preferred stock	1,138	913	904
Net income available to common shareholders	$ 6,493	$ 8,961	$ 1,896
Earnings per common share, basic and diluted	$ 1.32	$ 1.83	$ 0.48

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income

Three years ended December 31, 2014

(in thousands)

	2014	2013	2012
Net income	$ 7,631	$ 9,874	$ 2,800
Other comprehensive loss, net of tax:			
Unrealized holding gains (loss) on available for sale securities, net of tax $750, ($1,493) and $0, respectively	1,456	(2,899)	(111)
Reclassification adjustment for gains included in net income, net of tax ($236), $0 and $0, respectively	(460)		(1,285)
Pension liability adjustment, net of tax ($642), $1,264 and $0, respectively	(1,246)	2,454	(454)
Total other comprehensive loss	(250)	(445)	(1,850)
Total comprehensive income	$ 7,381	$ 9,429	$ 950

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Three years ended December 31, 2014

(in thousands)

	2014	2013	2012
Cash Flows from Operating Activities			
Net income	$ 7,631	$ 9,874	$ 2,800
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	967	1,011	1,110
Origination of loans held for sale	(1,503)	(2,567)	(8,627)
Proceeds from sale of loans held for sale	2,645	3,263	8,612