

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 12, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2016**

**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)**

<b>Virginia</b> <b>(State or other jurisdiction of</b>	<b>54-1232965</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>112 West King Street, Strasburg, Virginia</b> <b>(Address of principal executive offices)</b>	<b>22657</b> <b>(Zip Code)</b>
<b>(540) 465-9121</b> <b>(Registrant's telephone number, including area code)</b>	

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

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input checked="" type="checkbox"/>

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of August 12, 2016, 4,925,599 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****FIRST NATIONAL CORPORATION****Consolidated Balance Sheets***(in thousands, except share and per share data)*

	(unaudited) June 30, 2016	December 31, 2015*
<b>Assets</b>		
Cash and due from banks	\$ 10,518	\$ 8,247
Interest-bearing deposits in banks	40,225	31,087
Securities available for sale, at fair value	94,566	105,559
Securities held to maturity, at carrying value (fair value, 2016, \$58,375; 2015, \$66,438)	57,401	66,519
Restricted securities, at cost	2,058	1,391
Loans held for sale	1,819	323
Loans, net of allowance for loan losses, 2016, \$5,734; 2015, \$5,524	459,812	433,475
Other real estate owned, net of valuation allowance, 2016, \$181; 2015, \$224	442	2,679
Premises and equipment, net	21,126	21,389
Accrued interest receivable	1,612	1,661
Bank owned life insurance	13,935	11,742
Core deposit intangibles, net	1,917	2,322
Other assets	5,917	5,927
<b>Total assets</b>	<b>\$ 711,348</b>	<b>\$ 692,321</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 159,278	\$ 157,070
Savings and interest-bearing demand deposits	337,589	328,945
Time deposits	133,479	141,101
<b>Total deposits</b>	<b>\$ 630,346</b>	<b>\$ 627,116</b>
Other borrowings	12,000	
Subordinated debt	4,921	4,913
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	5,544	5,060
<b>Total liabilities</b>	<b>\$ 662,090</b>	<b>\$ 646,368</b>

**Shareholders' Equity**

Preferred stock, par value \$1.25 per share; authorized 1,000,000 shares; none issued and outstanding	\$	\$
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2016, 4,925,599 shares; 2015, 4,916,130 shares	6,157	6,145
Surplus	7,021	6,956
Retained earnings	36,676	34,440
Accumulated other comprehensive loss, net	(596)	(1,588)
Total shareholders' equity	\$ 49,258	\$ 45,953
Total liabilities and shareholders' equity	\$ 711,348	\$ 692,321

\* Derived from audited consolidated financial statements.  
*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2016 and 2015

*(in thousands, except per share data)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 5,370	\$ 4,688
Interest on deposits in banks	62	68
Interest and dividends on securities available for sale:		
Taxable interest	683	540
Tax-exempt interest	142	78
Dividends	21	18
 Total interest and dividend income	 \$ 6,278	 \$ 5,392
<b>Interest Expense</b>		
Interest on deposits	\$ 329	\$ 266
Interest on federal funds purchased		1
Interest on subordinated debt	89	
Interest on junior subordinated debt	64	55
Interest on other borrowings		2
 Total interest expense	 \$ 482	 \$ 324
 Net interest income	 \$ 5,796	 \$ 5,068
Recovery of loan losses		(100)
 Net interest income after recovery of loan losses	 \$ 5,796	 \$ 5,168
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 914	\$ 752
ATM and check card fees	515	497
Wealth management fees	334	499
Fees for other customer services	137	184
Income from bank owned life insurance	107	90
Net gains on sale of loans	31	50
Bargain purchase gain		201
Other operating income	74	36
 Total noninterest income	 \$ 2,112	 \$ 2,309

<b>Noninterest Expense</b>		
Salaries and employee benefits	\$ 3,415	\$ 3,597
Occupancy	365	339
Equipment	394	422
Marketing	120	163
Supplies	103	229
Legal and professional fees	156	431
ATM and check card fees	221	190
FDIC assessment	126	64
Bank franchise tax	90	130
Telecommunications expense	115	100
Data processing expense	146	226
Postage expense	57	80
Amortization expense	198	196
Other real estate owned (income) expense, net	(49)	152
Other operating expense	426	536
<b>Total noninterest expense</b>	<b>\$ 5,883</b>	<b>\$ 6,855</b>

*See Notes to Consolidated Financial Statements*

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

(Continued)

Three months ended June 30, 2016 and 2015

*(in thousands, except per share data)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
Income before income taxes	\$ 2,025	\$ 622
Income tax expense	592	178
<b>Net income</b>	<b>\$ 1,433</b>	<b>\$ 444</b>
Effective dividend on preferred stock		328
<b>Net income available to common shareholders</b>	<b>\$ 1,433</b>	<b>\$ 116</b>
<b>Earnings per common share</b>		
Basic	\$ 0.29	\$ 0.02
Diluted	\$ 0.29	\$ 0.02

*See Notes to Consolidated Financial Statements*



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

Three months ended June 30, 2016 and 2015

*(in thousands)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
Net income	\$ 1,433	\$ 444
Other comprehensive income (loss), net of tax, Unrealized holding gains (losses) on available for sale securities, net of tax \$126 and (\$457), respectively	247	(886)
<b>Total other comprehensive income (loss)</b>	<b>247</b>	<b>(886)</b>
Total comprehensive income (loss)	\$ 1,680	\$ (442)

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2016 and 2015

*(in thousands, except per share data)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 10,606	\$ 9,228
Interest on deposits in banks	110	73
Interest and dividends on securities available for sale:		
Taxable interest	1,424	898
Tax-exempt interest	289	142
Dividends	40	39
 Total interest and dividend income	 \$ 12,469	 \$ 10,380
<b>Interest Expense</b>		
Interest on deposits	\$ 662	\$ 566
Interest on federal funds purchased	3	2
Interest on subordinated debt	179	
Interest on junior subordinated debt	125	109
Interest on other borrowings	5	3
 Total interest expense	 \$ 974	 \$ 680
 Net interest income	 \$ 11,495	 \$ 9,700
Recovery of loan losses		(100)
 Net interest income after recovery of loan losses	 \$ 11,495	 \$ 9,800
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,694	\$ 1,299
ATM and check card fees	1,003	846
Wealth management fees	670	1,002
Fees for other customer services	284	291
Income from bank owned life insurance	193	164
Net gains (losses) on calls and sales of securities available for sale	6	(52)
Net gains on sale of loans	52	105
Bargain purchase gain		201
Other operating income	153	44

Total noninterest income	\$ 4,055	\$ 3,900
<b>Noninterest Expense</b>		
Salaries and employee benefits	\$ 6,859	\$ 6,722
Occupancy	789	656
Equipment	826	703
Marketing	227	260
Supplies	204	574
Legal and professional fees	467	643
ATM and check card fees	426	345
FDIC assessment	248	131
Bank franchise tax	193	252
Telecommunications expense	229	185
Data processing expense	274	413
Postage expense	126	197
Amortization expense	405	200
Other real estate owned (income) expense, net	(121)	116
Other operating expense	848	945
Total noninterest expense	\$ 12,000	\$ 12,342

*See Notes to Consolidated Financial Statements*

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

(Continued)

Six months ended June 30, 2016 and 2015

*(in thousands, except per share data)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
Income before income taxes	\$ 3,550	\$ 1,358
Income tax expense	1,018	370
<b>Net income</b>	<b>\$ 2,532</b>	<b>\$ 988</b>
Effective dividend on preferred stock		657
<b>Net income available to common shareholders</b>	<b>\$ 2,532</b>	<b>\$ 331</b>
<b>Earnings per common share</b>		
Basic	\$ 0.51	\$ 0.07
Diluted	\$ 0.51	\$ 0.07

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2016 and 2015

*(in thousands)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
Net income	\$ 2,532	\$ 988
Other comprehensive income (loss), net of tax, Unrealized holding gains (losses) on available for sale securities, net of tax \$515 and (\$164), respectively	996	(316)
Reclassification adjustment for (gains) losses included in net income, net of tax (\$2) and \$18, respectively	(4)	34
Total other comprehensive income (loss)	992	(282)
Total comprehensive income	\$ 3,524	\$ 706

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2016 and 2015

*(in thousands)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 2,532	\$ 988
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	669	566
Amortization of core deposit intangibles	405	200
Amortization of debt issuance costs	8	
Origination of loans held for sale	(5,106)	(7,781)
Proceeds from sale of loans held for sale	3,662	6,236
Net gains on sales of loans held for sale	(52)	(105)
Recovery of loan losses		(100)
Net (gains) losses on sale of securities available for sale	(6)	52
Provision for other real estate owned	27	137
Net gains on sale of other real estate owned	(191)	(72)
Income from bank owned life insurance	(193)	(164)
Accretion of discounts and amortization of premiums on securities, net	437	311
Accretion of premium on time deposits	(94)	(81)
Stock-based compensation	56	52
Bargain purchase gain on branch acquisition		(201)
Deferred income tax expense	349	78
Changes in assets and liabilities:		
Decrease (increase) in interest receivable	49	(162)
Increase in other assets	(440)	(380)
Increase in other liabilities	74	1,290
Net cash provided by operating activities	\$ 2,186	\$ 864
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities, calls, principal payments, and sales of securities available for sale	12,217	7,690
Proceeds from maturities, calls, principal payments, and sales of securities held to maturity	8,966	240
Purchase of securities available for sale		(37,638)
Purchase of securities held to maturity		(37,602)
Net purchase of restricted securities	(667)	(25)
Purchase of premises and equipment	(406)	(1,222)

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Proceeds from sale of other real estate owned	2,438	354
Purchase of bank owned life insurance	(2,000)	
Net increase in loans	(26,374)	(14,738)
Acquisition of branches, net of cash paid		179,501
Net cash (used in) provided by investing activities	\$ (5,826)	\$ 96,560
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 10,852	\$ 1,528
Net decrease in time deposits	(7,528)	(11,705)
Net increase (decrease) in other borrowings	12,000	(13)
Cash dividends paid on common stock, net of reinvestment	(275)	(226)
Cash dividends paid on preferred stock		(657)
Decrease in federal funds purchased		(52)
Net cash provided by (used in) financing activities	\$ 15,049	\$ (11,125)

*See Notes to Consolidated Financial Statements*

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

(Continued)

Six months ended June 30, 2016 and 2015

*(in thousands)*

	(unaudited) June 30, 2016	(unaudited) June 30, 2015
Increase in cash and cash equivalents	\$ 11,409	\$ 86,299
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 39,334	\$ 24,845
Ending	\$ 50,743	\$ 111,144
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 1,088	\$ 617
Income Taxes	\$ 1,276	\$ 752
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gains on securities available for sale	\$ 1,505	\$ 428
Transfer from loans to other real estate owned	\$ 37	\$ 938
Issuance of common stock, dividend reinvestment plan	\$ 21	\$ 20
<b>Transactions Related to Acquisition</b>		
Assets acquired	\$	\$ 193,638
Liabilities assumed		186,819
Net assets acquired	\$	\$ 6,819

*See Notes to Consolidated Financial Statements*



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

Six months ended June 30, 2016 and 2015

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

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2014</b>	\$ 14,595	\$ 6,131	\$ 6,835	\$ 33,557	\$ (1,554)	\$ 59,564
Net income				988		988
Other comprehensive loss					(282)	(282)
Cash dividends on common stock (\$0.05 per share)				(246)		(246)
Stock-based compensation			52			52
Issuance of 2,067 shares common stock, dividend reinvestment plan		3	17			20
Issuance of 4,182 shares common stock, stock incentive plan		5	(5)			
Cash dividends on preferred stock				(657)		(657)
<b>Balance, June 30, 2015</b>	\$ 14,595	\$ 6,139	\$ 6,899	\$ 33,642	\$ (1,836)	\$ 59,439

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2015</b>	\$	\$ 6,145	\$ 6,956	\$ 34,440	\$ (1,588)	\$ 45,953
Net income				2,532		2,532
Other comprehensive income					992	992
Cash dividends on common stock (\$0.06 per share)				(296)		(296)
Stock-based compensation			56			56
Issuance of 2,245 shares common stock, dividend reinvestment plan		3	18			21
Issuance of 7,224 shares common stock, stock incentive plan		9	(9)			
<b>Balance, June 30, 2016</b>	\$	\$ 6,157	\$ 7,021	\$ 36,676	\$ (596)	\$ 49,258

*See Notes to Consolidated Financial Statements*

**Table of Contents**

**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements**

*(unaudited)*

**Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiary, First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2016 and December 31, 2015, the statements of income and comprehensive income (loss) for the three and six months ended June 30, 2016 and 2015 and the cash flows and changes in shareholders' equity for the six months ended June 30, 2016 and 2015. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2015. Operating results for the three and six month periods ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

**Recent Accounting Pronouncements**

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have an impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of ASU 2016-01 to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

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

In March 2016, the FASB issued ASU No. 2016-07, *Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*. Among other things, the amendments in ASU 2016-07, eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The amendments require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

During June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities at June 30, 2016 and December 31, 2015 were as follows (in thousands):

	June 30, 2016			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
<b>Securities available for sale:</b>				
U.S. agency and mortgage-backed securities	\$ 78,864	\$ 929	\$ (119)	\$ 79,674
Obligations of states and political subdivisions	14,488	396	(8)	14,876
Corporate equity securities	1	15		16
<b>Total securities available for sale</b>	<b>\$ 93,353</b>	<b>\$ 1,340</b>	<b>\$ (127)</b>	<b>\$ 94,566</b>
<b>Securities held to maturity:</b>				
U.S. agency and mortgage-backed securities	\$ 41,239	\$ 415	\$ (19)	\$ 41,635
Obligations of states and political subdivisions	14,662	543		15,205
Corporate debt securities	1,500	35		1,535
<b>Total securities held to maturity</b>	<b>\$ 57,401</b>	<b>\$ 993</b>	<b>\$ (19)</b>	<b>\$ 58,375</b>
<b>Total securities</b>	<b>\$ 150,754</b>	<b>\$ 2,333</b>	<b>\$ (146)</b>	<b>\$ 152,941</b>

	December 31, 2015			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
<b>Securities available for sale:</b>				
U.S. agency and mortgage-backed securities	\$ 89,919	\$ 261	\$ (843)	\$ 89,337
Obligations of states and political subdivisions	15,931	333	(50)	16,214
Corporate equity securities	1	7		8
<b>Total securities available for sale</b>	<b>\$ 105,851</b>	<b>\$ 601</b>	<b>\$ (893)</b>	<b>\$ 105,559</b>
<b>Securities held to maturity:</b>				
U.S. agency and mortgage-backed securities	\$ 49,662	\$ 36	\$ (326)	\$ 49,372

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Obligations of states and political subdivisions	15,357	228	(19)	15,566
Corporate debt securities	1,500			1,500
Total securities held to maturity	\$ 66,519	\$ 264	\$ (345)	\$ 66,438
Total securities	\$ 172,370	\$ 865	\$ (1,238)	\$ 171,997

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At June 30, 2016 and December 31, 2015, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	Less than 12 months		June 30, 2016 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
<b>Securities available for sale:</b>						
U.S. agency and mortgage-backed securities	\$ 780	\$ (1)	\$ 12,133	\$ (118)	\$ 12,913	\$ (119)
Obligations of states and political subdivisions			522	(8)	522	(8)
<b>Total securities available for sale</b>	<b>\$ 780</b>	<b>\$ (1)</b>	<b>\$ 12,655</b>	<b>\$ (126)</b>	<b>\$ 13,435</b>	<b>\$ (127)</b>
<b>Securities held to maturity:</b>						
U.S. agency and mortgage-backed securities	\$	\$	\$ 6,032	\$ (19)	\$ 6,032	\$ (19)
<b>Total securities held to maturity</b>	<b>\$</b>	<b>\$</b>	<b>\$ 6,032</b>	<b>\$ (19)</b>	<b>\$ 6,032</b>	<b>\$ (19)</b>
<b>Total securities</b>	<b>\$ 780</b>	<b>\$ (1)</b>	<b>\$ 18,687</b>	<b>\$ (145)</b>	<b>\$ 19,467</b>	<b>\$ (146)</b>
	Less than 12 months		December 31, 2015 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
<b>Securities available for sale:</b>						
U.S. agency and mortgage-backed securities	\$ 50,185	\$ (464)	\$ 13,409	\$ (379)	\$ 63,594	\$ (843)
Obligations of states and political subdivisions	2,395	(15)	1,053	(35)	3,448	(50)
<b>Total securities available for sale</b>	<b>\$ 52,580</b>	<b>\$ (479)</b>	<b>\$ 14,462</b>	<b>\$ (414)</b>	<b>\$ 67,042</b>	<b>\$ (893)</b>
<b>Securities held to maturity:</b>						
U.S. agency and mortgage-backed securities	\$ 32,791	\$ (326)	\$	\$	\$ 32,791	\$ (326)



Obligations of states and political subdivisions	3,052	(19)			3,052	(19)
Total securities held to maturity	\$ 35,843	\$ (345)	\$	\$	\$ 35,843	\$ (345)
Total securities	\$ 88,423	\$ (824)	\$ 14,462	\$ (414)	\$ 102,885	\$ (1,238)

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

At June 30, 2016, there were thirteen U.S. agency and mortgage-backed securities and one obligation of a state and political subdivision in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.9 years at June 30, 2016. At December 31, 2015, there were fifty-two U.S. agency and mortgage-backed securities and thirteen obligations of states and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio was considered investment grade at December 31, 2015. The weighted-average re-pricing term of the portfolio was 4.6 years at December 31, 2015. The unrealized losses at June 30, 2016 in the U.S. agency and mortgage-backed securities portfolio and the obligation of states and political subdivisions portfolio were related to changes in market interest rates and not credit concerns of the issuers.

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

For the three and six months ended June 30, 2016, the Company sold one security from the held to maturity portfolio. The Company recognized no gain or loss related to the sale as the carrying value of the security sold equaled the proceeds from the sale of \$657 thousand. The sale of this security was in response to credit deterioration of the issuer. There were no sales of securities from the held to maturity portfolio for the three and six month periods ended June 30, 2015.

The amortized cost and fair value of securities at June 30, 2016 by contractual maturity are shown below (in thousands). Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties. Corporate equity securities are not included in the maturity categories in the following maturity summary because they do not have a stated maturity date.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$ 1,666	\$ 1,672	\$	\$
Due after one year through five years	9,649	9,769	1,111	1,131
Due after five years through ten years	13,246	13,578	16,355	16,761
Due after ten years	68,791	69,531	39,935	40,483
Corporate equity securities	1	16		
	\$ 93,353	\$ 94,566	\$ 57,401	\$ 58,375

Federal Home Loan Bank, Federal Reserve Bank and Community Bankers Bank stock are generally viewed as long-term investments and as restricted securities, which are carried at cost, because there is a minimal market for the stock. Therefore, when evaluating restricted securities for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider these investments to be other-than-temporarily impaired at June 30, 2016, and no impairment has been recognized.

The composition of restricted securities at June 30, 2016 and December 31, 2015 was as follows (in thousands):

	June 30, 2016	December 31, 2015
Federal Home Loan Bank stock	\$ 1,133	\$ 466
Federal Reserve Bank stock	875	875
Community Bankers Bank stock	50	50

\$ 2,058      \$ 1,391

**Note 3. Loans**

Loans at June 30, 2016 and December 31, 2015 are summarized as follows (in thousands):

	June 30, 2016	December 31, 2015
<b>Real estate loans:</b>		
Construction and land development	\$ 33,232	\$ 33,135
Secured by 1-4 family residential	196,295	189,286
Other real estate loans	200,162	181,447
Commercial and industrial loans	24,721	24,048
Consumer and other loans	11,136	11,083
<b>Total loans</b>	<b>\$ 465,546</b>	<b>\$ 438,999</b>
Allowance for loan losses	(5,734)	(5,524)
<b>Loans, net</b>	<b>\$ 459,812</b>	<b>\$ 433,475</b>

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**Notes to Consolidated Financial Statements**

*(unaudited)*

Net deferred loan fees included in the above loan categories were \$67 thousand at June 30, 2016 and net deferred loan costs included in the above loan categories were \$54 thousand at December 31, 2015. Consumer and other loans included \$334 thousand and \$257 thousand of demand deposit overdrafts at June 30, 2016 and December 31, 2015, respectively.

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

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 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.

Commercial and industrial loans carry risks associated with the successful operation of a business because repayment of these loans may be dependent upon the profitability and cash flows of the business. 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 creditworthiness 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.

The following tables provide a summary of loan classes and an aging of past due loans as of June 30, 2016 and December 31, 2015 (in thousands):

June 30, 2016  
Current

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	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
<b>Real estate loans:</b>							
Construction and land development	\$ 111	\$ 126	\$	\$ 237	\$ 32,995	\$ 33,232	\$ 1,539
Secured by 1-4 family residential	768	202	269	1,239	195,056	196,295	345
Other real estate loans	331	590	125	1,046	199,116	200,162	2,089
Commercial and industrial	9	34	8	51	24,670	24,721	84
Consumer and other loans	14		3	17	11,119	11,136	3
<b>Total</b>	<b>\$ 1,233</b>	<b>\$ 952</b>	<b>\$ 405</b>	<b>\$ 2,590</b>	<b>\$ 462,956</b>	<b>\$ 465,546</b>	<b>\$ 4,057</b>

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December 31, 2015

	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
<b>Real estate loans:</b>								
Construction and land development	\$	\$	\$	\$	\$ 33,135	\$ 33,135	\$ 1,269	\$
Secured by 1-4 family residential	635	18	264	917	188,369	189,286	346	
Other real estate loans	387	358	790	1,535	179,912	181,447	2,145	
Commercial and industrial			92	92	23,956	24,048	94	92
Consumer and other loans	20			20	11,063	11,083		
<b>Total</b>	<b>\$ 1,042</b>	<b>\$ 376</b>	<b>\$ 1,146</b>	<b>\$ 2,564</b>	<b>\$ 436,435</b>	<b>\$ 438,999</b>	<b>\$ 3,854</b>	<b>\$ 92</b>

**Credit Quality Indicators**

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

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

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

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

will sustain some loss if the deficiencies are not corrected.

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

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

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The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2016 and December 31, 2015 (in thousands):

	June 30, 2016				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 27,121	\$ 2,095	\$ 4,016	\$	\$ 33,232
Secured by 1-4 family residential	190,518	2,566	3,211		196,295
Other real estate loans	185,740	8,330	6,092		200,162
Commercial and industrial	24,166	401	154		24,721
Consumer and other loans	11,136				11,136
<b>Total</b>	<b>\$ 438,681</b>	<b>\$ 13,392</b>	<b>\$ 13,473</b>	<b>\$</b>	<b>\$ 465,546</b>

	December 31, 2015				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 26,371	\$ 2,587	\$ 4,177	\$	\$ 33,135
Secured by 1-4 family residential	182,595	3,376	3,315		189,286
Other real estate loans	165,310	9,977	6,160		181,447
Commercial and industrial	23,351	432	265		24,048
Consumer and other loans	11,083				11,083
<b>Total</b>	<b>\$ 408,710</b>	<b>\$ 16,372</b>	<b>\$ 13,917</b>	<b>\$</b>	<b>\$ 438,999</b>

**Note 4. Allowance for Loan Losses**

The following tables present, as of June 30, 2016, December 31, 2015 and June 30, 2015, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology (in thousands):

		June 30, 2016			Total
Construction and Land Development	Secured by 1-4 Family	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	



## Residential

**Allowance for loan losses:**

Beginning Balance, December 31, 2015	\$ 1,532	\$ 939	\$ 2,534	\$ 306	\$ 213	\$ 5,524
Charge-offs		(2)			(254)	(256)
Recoveries	2	279	1	7	177	466
Provision for (recovery of) loan losses	(865)	(178)	874	3	166	
Ending Balance, June 30, 2016	\$ 669	\$ 1,038	\$ 3,409	\$ 316	\$ 302	\$ 5,734

**Ending Balance:**

Individually evaluated for impairment			184			184
Collectively evaluated for impairment	669	1,038	3,225	316	302	5,550

**Loans:**

Ending Balance	33,232	196,295	200,162	24,721	11,136	465,546
Individually evaluated for impairment	2,664	2,022	2,614	84		7,384
Collectively evaluated for impairment	30,568	194,273	197,548	24,637	11,136	458,162

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	December 31, 2015					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2014	\$ 1,403	\$ 1,204	\$ 3,658	\$ 310	\$ 143	\$ 6,718
Charge-offs		(142)	(1,125)	(59)	(512)	(1,838)
Recoveries	4	373	2	72	293	744
Provision for (recovery of) loan losses	125	(496)	(1)	(17)	289	(100)
Ending Balance, December 31, 2015	\$ 1,532	\$ 939	\$ 2,534	\$ 306	\$ 213	\$ 5,524
<b>Ending Balance:</b>						
Individually evaluated for impairment	326	23	195			544
Collectively evaluated for impairment	1,206	916	2,339	306	213	4,980
<b>Loans:</b>						
Ending Balance	33,135	189,286	181,447	24,048	11,083	438,999
Individually evaluated for impairment	2,544	2,044	3,023	94		7,705
Collectively evaluated for impairment	30,591	187,242	178,424	23,954	11,083	431,294

	June 30, 2015					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2014	\$ 1,403	\$ 1,204	\$ 3,658	\$ 310	\$ 143	\$ 6,718
Charge-offs		(47)	(471)	(59)	(206)	(783)
Recoveries	2	83	1	62	146	294
Provision for (recovery of) loan losses	204	(314)	(16)	(55)	81	(100)

Ending Balance, June 30, 2015	\$ 1,609	\$ 926	\$ 3,172	\$ 258	\$ 164	\$ 6,129
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**Ending Balance:**

Individually evaluated for impairment	437	79	1,025	22		1,563
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Collectively evaluated for impairment	1,172	847	2,147	236	164	4,566
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**Loans:**

Ending Balance	32,009	173,265	155,396	19,319	11,732	391,721
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Individually evaluated for impairment	3,319	2,387	4,944	120		10,770
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Collectively evaluated for impairment	28,690	170,878	150,452	19,199	11,732	380,951
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Impaired loans and the related allowance at June 30, 2016, December 31, 2015 and June 30, 2015, were as follows (in thousands):

	June 30, 2016						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction and land development	\$ 2,900	\$ 2,664	\$	\$ 2,664	\$	\$ 2,545	\$ 31
Secured by 1-4 family	2,041	2,022		2,022		2,051	52
Other real estate loans	3,191	2,066	548	2,614	184	2,965	17
Commercial and industrial	100	84		84		90	
Consumer and other loans							
<b>Total</b>	<b>\$ 8,232</b>	<b>\$ 6,836</b>	<b>\$ 548</b>	<b>\$ 7,384</b>	<b>\$ 184</b>	<b>\$ 7,651</b>	<b>\$ 100</b>

	December 31, 2015						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction and land development	\$ 2,741	\$ 2,206	\$ 338	\$ 2,544	\$ 326	\$ 2,967	\$ 60
Secured by 1-4 family	2,116	2,021	23	2,044	23	2,526	107
Other real estate loans	3,492	2,463	560	3,023	195	4,933	58
Commercial and industrial	107	94		94		118	
Consumer and other loans							
<b>Total</b>	<b>\$ 8,456</b>	<b>\$ 6,784</b>	<b>\$ 921</b>	<b>\$ 7,705</b>	<b>\$ 544</b>	<b>\$ 10,544</b>	<b>\$ 225</b>

	June 30, 2015						
	Unpaid Principal	Recorded Investment	Recorded Investment	Total Recorded	Related Allowance	Average Recorded	Interest Income

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	Balance	with No	with	Investment		Investment Recognized	
		Allowance	Allowance				
Real estate loans:							
Construction and land development	\$ 3,464	\$ 2,684	\$ 635	\$ 3,319	\$ 437	\$ 3,165	\$ 31
Secured by 1-4 family	2,476	2,155	232	2,387	79	2,864	57
Other real estate loans	5,416	2,453	2,491	4,944	1,025	6,828	34
Commercial and industrial	130	16	104	120	22	137	2
Consumer and other loans							
<b>Total</b>	<b>\$ 11,486</b>	<b>\$ 7,308</b>	<b>\$ 3,462</b>	<b>\$ 10,770</b>	<b>\$ 1,563</b>	<b>\$ 12,994</b>	<b>\$ 124</b>

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

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As of June 30, 2016, one loan totaling \$660 thousand was classified as a troubled debt restructuring (TDR) and included in impaired loans in the disclosure above. At June 30, 2016, the loan classified as a TDR was not performing under the restructured terms and was considered a non-performing asset. There were \$982 thousand in TDRs at December 31, 2015, \$317 thousand of which were performing under the restructured terms. Modified terms under TDRs may include rate reductions, extension of terms that are considered to be below market, conversion to interest only, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. There were no loans modified under TDRs during the three and six month periods ended June 30, 2016 and 2015.

For the three and six months ended June 30, 2016 and 2015, there were no troubled debt restructurings that subsequently defaulted within twelve months of the loan modification. Management defines default as over ninety days past due or the foreclosure and repossession of the collateral or charge-off of the loan during the twelve month period subsequent to the modification.

**Note 5. Other Real Estate Owned (OREO)**

Changes in the balance for OREO are as follows (in thousands):

	For the six months ended June 30, 2016	For the year ended December 31, 2015
Balance at the beginning of year, gross	\$ 2,903	\$ 2,263
Transfers in	37	1,664
Charge-offs	(70)	(381)
Sales proceeds	(2,438)	(717)
Gain on disposition	191	74
Balance at the end of period, gross	\$ 623	\$ 2,903
Less: valuation allowance	(181)	(224)
Balance at the end of period, net	\$ 442	\$ 2,679

The carrying amounts of residential real estate properties included in the ending OREO balances above were \$442 thousand and \$627 thousand at June 30, 2016 and December 31, 2015, respectively. The Bank did not have any consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process as of June 30, 2016.

Changes in the valuation allowance are as follows (in thousands):

	For the six		For the year ended December 31, 2015
	months ended		
	June 30, 2016	June 30, 2015	
Balance at beginning of year	\$ 224	\$ 375	\$ 375
Provision for losses	27	137	230
Charge-offs, net	(70)	(375)	(381)
Balance at end of period	\$ 181	\$ 137	\$ 224

Net expenses applicable to OREO, other than the provision for losses, were \$43 thousand and \$51 thousand for the six months ended June 30, 2016 and 2015, respectively and \$196 thousand for the year ended December 31, 2015.

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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 6. Other Borrowings**

The Bank had unused lines of credit totaling \$118.6 million and \$128.1 million available with non-affiliated banks at June 30, 2016 and December 31, 2015, respectively. These amounts primarily consist of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) in which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled \$74.5 million at June 30, 2016. The Bank had collateral pledged on the borrowing line at June 30, 2016 and December 31, 2015 including real estate loans totaling \$108.0 million and \$105.1 million, respectively, and Federal Home Loan Bank stock with a book value of \$1.1 million and \$466 thousand, respectively.

At June 30, 2016, the Bank had borrowings from the FHLB totaling \$12.0 million which matured July 1, 2016. The interest rate on this note payable was 0.57%. The Bank did not have borrowings from the FHLB at December 31, 2015.

**Note 7. Capital Requirements**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective January 1, 2015, with full compliance of all the requirements being phased in over a multi-year schedule, and becoming fully phased in by January 1, 2019. As part of the new requirements, the common equity Tier 1 capital ratio is calculated and utilized in the assessment of capital for all institutions. The final rules also established a capital conservation buffer above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years beginning on January 1, 2016.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total (as defined in the regulations), Tier 1 (as defined), and common equity Tier 1 capital (as defined) to risk-weighted assets (as defined), and of Tier 1 capital to average assets. Management believes, as of June 30, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject.

As of June 30, 2016, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum risk-based capital and leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.



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A comparison of the capital of the Bank at June 30, 2016 and December 31, 2015 with the minimum regulatory guidelines were as follows (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>June 30, 2016:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 64,375	13.66%	\$ 37,692	8.00%	\$ 47,115	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 58,641	12.45%	\$ 28,269	6.00%	\$ 37,692	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 58,641	12.45%	\$ 21,202	4.50%	\$ 30,625	6.50%
Tier 1 Capital (to Average Assets)	\$ 58,641	8.33%	\$ 28,175	4.00%	\$ 35,219	5.00%
<b>December 31, 2015:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 61,513	13.86%	\$ 35,497	8.00%	\$ 44,372	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 55,989	12.62%	\$ 26,623	6.00%	\$ 35,497	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 55,989	12.62%	\$ 19,967	4.50%	\$ 28,842	6.50%
Tier 1 Capital (to Average Assets)	\$ 55,989	8.12%	\$ 27,571	4.00%	\$ 34,464	5.00%

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**Notes to Consolidated Financial Statements**

*(unaudited)*

**Note 8. Subordinated Debt**

On October 30, 2015, the Company entered into a Subordinated Loan Agreement (the Agreement) pursuant to which the Company issued an interest only subordinated term note due 2025 in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note qualifies as Tier 2 capital for regulatory capital purposes and at June 30, 2016, the total amount of subordinated debt issued was included in the Company's Tier 2 capital.

The Note has a maturity date of October 1, 2025. Subject to regulatory approval, the Company may prepay the Note, in part or in full, beginning on October 30, 2020. The Note is an unsecured, subordinated obligation of the Company and ranks junior in right of payment to the Company's senior indebtedness and to the Company's obligations to its general creditors. The Note ranks equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the Note. The Note ranks senior to all current and future junior subordinated debt obligations, preferred stock and common stock of the Company.

The Note is not convertible into common stock or preferred stock. The Agreement contains customary events of default such as the bankruptcy of the Company and the non-payment of principal or interest when due. The holder of the Note may accelerate the repayment of the Note only in the event of bankruptcy or similar proceedings and not for any other event of default.

**Note 9. Junior Subordinated Debt**

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at June 30, 2016 and December 31, 2015 was 3.26% and 3.13%, respectively. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the junior subordinated debt.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, \$4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at June 30, 2016 and December 31, 2015 was 2.23% and 1.93%, respectively. The securities have a mandatory redemption date of October 1, 2036, and were subject to varying call provisions that began October 1, 2011. The principal asset of Trust III is \$4.1 million of the Company's junior subordinated debt with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the junior subordinated debt.

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the junior subordinated debt 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 junior subordinated debt. The portion of the junior subordinated debt not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2016 and December 31, 2015, the total amount of junior subordinated debt issued by the Trusts was included in the Company's Tier 1 capital.

**Note 10. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. Effective May 1, 2011, the plan was frozen to new participants. Only individuals employed on or before April 30, 2011 were eligible to become participants in the plan upon satisfaction of the eligibility requirements. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank's funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

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Components of the net periodic benefit cost of the plan for the three and six months ended June 30, 2016 and 2015 were as follows (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Service cost	\$ 103	\$ 112	\$ 205	\$ 223
Interest cost	83	75	166	151
Expected return on plan assets	(75)	(78)	(149)	(157)
Amortization of net loss	21	21	42	43
<b>Net periodic benefit cost</b>	<b>\$ 132</b>	<b>\$ 130</b>	<b>\$ 264</b>	<b>\$ 260</b>

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2015, that it expected to make no contribution to its pension plan during the year ended December 31, 2016. There was no minimum annual contribution required.

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. See Note 13 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 for additional information about the Company's benefit plans.

**Note 11. Earnings per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

The following table presents the computation of basic and diluted earnings per share for the three and six months ended June 30, 2016 and 2015 (dollars in thousands, except per share data):

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
(Numerator):				
Net income	\$ 1,433	\$ 444	\$ 2,532	\$ 988
		328		657

**Effective dividend and accretion on preferred stock**

Net income available to common shareholders	\$ 1,433	\$ 116	\$ 2,532	\$ 331
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**(Denominator):**

Weighted average shares outstanding basic	4,924,702	4,909,775	4,922,509	4,908,386
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Potentially dilutive common shares restricted stock units	2,157	1,523	2,089	2,793
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Weighted average shares outstanding diluted	4,926,859	4,911,298	4,924,598	4,911,179
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**Income per common share**

Basic	\$ 0.29	\$ 0.02	\$ 0.51	\$ 0.07
Diluted	\$ 0.29	\$ 0.02	\$ 0.51	\$ 0.07

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**Notes to Consolidated Financial Statements**

*(unaudited)*

**Note 12. Fair Value Measurements**

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

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

**Fair Value Hierarchy**

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

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

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

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

Securities available for sale

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

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The following tables present the balances of assets measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015 (in thousands).

Description	Fair Value Measurements at June 30, 2016			
	Balance as of June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 79,674	\$	\$ 79,674	\$
Obligations of states and political subdivisions	14,876		14,876	
Corporate equity securities	16	16		
	\$ 94,566	\$ 16	\$ 94,550	\$

Description	Fair Value Measurements at December 31, 2015			
	Balance as of December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 89,337	\$	\$ 89,337	\$
Obligations of states and political subdivisions	16,214		16,214	
Corporate equity securities	8	8		



\$ 105,559	\$ 8	\$ 105,551	\$
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Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

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

Loans held for sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during six months ended June 30, 2016 and the year ended December 31, 2015.

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

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. The measurement of loss associated with impaired loans can be based on the present value of expected future cash flows discounted at the loan's effective interest rate, the observable market price of the loan, or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2) within the last twelve months. However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for (or recovery of) loan losses on the Consolidated Statements of Income.

**Other real estate owned**

Loans are transferred to other real estate owned when the collateral securing them is foreclosed on or acquired through a deed in lieu of foreclosure. The measurement of loss associated with other real estate owned is based on the appraisal documents and assessed the same way as impaired loans described above. Any fair value adjustments are recorded in the period incurred as other real estate owned expense on the Consolidated Statements of Income.

The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis during the periods (dollars in thousands):

Description	Fair Value Measurements at June 30, 2016			
	Balance as of June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

			1)	
Impaired loans, net	\$	364	\$	\$ 364
Other real estate owned, net		442		442

Fair Value Measurements at December 31, 2015

Description	Balance as of December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 377	\$	\$	\$ 377
Other real estate owned, net	2,679			2,679

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

## Quantitative information about Level 3 Fair Value Measurements for June 30, 2016

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 364	Property appraisals	Selling cost	10%
Other real estate owned, net	\$ 442	Property appraisals	Selling cost	7%

## Quantitative information about Level 3 Fair Value Measurements for December 31, 2015

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 377	Property appraisals	Selling cost	2-10% (5%)
Other real estate owned, net	\$ 2,679	Property appraisals	Selling cost	7%

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

**Cash and Cash Equivalents and Federal Funds Sold**

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

**Securities Held to Maturity**

Certain debt securities that management has the positive intent and ability to hold until maturity are recorded at amortized cost. Fair values are determined in a manner that is consistent with securities available for sale.

**Restricted Securities**

The carrying value of restricted securities approximates fair value based on redemption provisions.

**Loans**

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

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**Notes to Consolidated Financial Statements**

*(unaudited)*

**Deposit Liabilities**

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

**Accrued Interest**

Accrued interest receivable and payable were estimated to equal the carrying value due to the short-term nature of these financial instruments.

**Borrowings and Federal Funds Purchased**

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

**Bank Owned Life Insurance**

Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of these policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

**Commitments and Unfunded Credits**

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

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At June 30, 2016 and December 31, 2015, fair value of loan commitments and standby letters of credit was immaterial.

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The carrying values and estimated fair values of the Company's financial instruments at June 30, 2016 and December 31, 2015 are as follows (in thousands):

	Carrying Amount	Fair Value Measurements at June 30, 2016 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Financial Assets</b>					
Cash and short-term investments	\$ 50,743	\$ 50,743	\$	\$	\$ 50,743
Securities available for sale	94,566	16	94,550		94,566
Securities held to maturity	57,401		56,840	1,535	58,375
Restricted securities	2,058		2,058		2,058
Loans held for sale	1,819		1,819		1,819
Loans, net	459,812			468,394	468,394
Bank owned life insurance	13,935		13,935		13,935
Accrued interest receivable	1,612		1,612		1,612
<b>Financial Liabilities</b>					
Deposits	\$ 630,346	\$	\$ 496,867	\$ 133,630	\$ 630,497
Other borrowings	12,000			11,998	11,998
Subordinated debt	4,921			5,013	5,013
Junior subordinated debt	9,279			8,111	8,111
Accrued interest payable	98		98		98

	Carrying Amount	Fair Value Measurements at December 31, 2015 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Financial Assets</b>					
Cash and short-term investments	\$ 39,334	\$ 39,334	\$	\$	\$ 39,334
Securities available for sale	105,559	8	105,551		105,559
Securities held to maturity	66,519		64,938	1,500	66,438

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Restricted securities	1,391		1,391		1,391
Loans held for sale	323		323		323
Loans, net	433,475			438,392	438,392
Bank owned life insurance	11,742		11,742		11,742
Accrued interest receivable	1,661		1,661		1,661
<b>Financial Liabilities</b>					
Deposits	\$ 627,116	\$	\$ 486,015	\$ 140,306	\$ 626,321
Subordinated debt	4,913			4,913	4,913
Junior subordinated debt	9,279			8,141	8,141
Accrued interest payable	117		117		117

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

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

**Note 13. Preferred Stock**

On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A at par for \$13.9 million and all 695 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series B at par for \$695 thousand.

Prior to redemption, the Company had (i) 13,900 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Preferred Stock) and (ii) 695 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series B, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Warrant Preferred Stock). The Preferred Stock paid cumulative dividends at a rate of 5% per annum until May 14, 2014, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock paid cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock was fully amortized over a five year period through March 12, 2014, using the constant effective yield method.

**Note 14. Stock Compensation Plans**

On May 13, 2014, the Company's shareholders approved the First National Corporation 2014 Stock Incentive Plan, which makes available up to 240,000 shares of common stock for the granting of stock options, restricted stock awards, stock appreciation rights and other stock-based awards. Awards are made at the discretion of the Board of Directors and compensation cost equal to the fair value of the award is recognized over the vesting period.

**Restricted Stock Units**

Restricted stock units are an award of units that correspond in number and value to a specified number of shares of employer stock which the recipient receives according to a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with the employer for a particular length of time. Each restricted stock unit that vests entitles the recipient to receive one share of common stock on a specified issuance date.

In the first quarter of 2016, 9,130 restricted stock units were granted to employees, with 3,047 units vesting immediately and 6,083 units subject to a two year vesting schedule with one half of the units vesting each year on the grant date anniversary. The recipient does not have any stockholder rights, including voting, dividend or liquidation



rights, with respect to the shares underlying awarded restricted stock units until vesting has occurred and the recipient becomes the record holder of those shares. The unvested restricted stock units will vest on the established schedule if the employees remain employed by the Company on future vesting dates.

A summary of the activity for the Company's restricted stock units for the period indicated is presented in the following table:

	June 30, 2016	
	Shares	Weighted Average Grant Date Fair Value
Unvested, beginning of period	8,353	\$ 9.00
Granted	9,130	8.80
Vested	(7,224)	8.92
Forfeited		
Unvested, end of period	10,259	\$ 8.88

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At June 30, 2016, based on restricted stock unit awards outstanding at that time, the total unrecognized pre-tax compensation expense related to unvested restricted stock unit awards was \$66 thousand. This expense is expected to be recognized through 2018. Compensation expense related to restricted stock unit awards recognized for the six months ended June 30, 2016 and 2015 totaled \$56 thousand and \$52 thousand, respectively. As of June 30, 2016, the Company does not expect the forfeiture of any unvested restricted stock units.

**Note 15. Accumulated Other Comprehensive Loss**

Changes in each component of accumulated other comprehensive loss were as follows (in thousands):

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
<b>Balance at December 31, 2014</b>	\$ (133)	\$ (1,421)	\$ (1,554)
Unrealized holding losses (net of tax, (\$164))	(316)		(316)
Reclassification adjustment (net of tax, (\$18))	34		34
Change during period	(282)		(282)
<b>Balance at June 30, 2015</b>	\$ (415)	\$ (1,421)	\$ (1,836)
<b>Balance at December 31, 2015</b>	\$ (192)	\$ (1,396)	\$ (1,588)
Unrealized holding gains (net of tax, \$515)	996		996
Reclassification adjustment (net of tax, \$2)	(4)		(4)
Change during period	992		992
<b>Balance at June 30, 2016</b>	\$ 800	\$ (1,396)	\$ (596)

The following table presents information related to reclassifications from accumulated other comprehensive loss for the six month periods ended June 30, 2016 and 2015 (in thousands). The Company did not have any reclassifications from accumulated comprehensive loss for the three month periods ended June 30, 2016 and 2015.

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss <b>For the six months ended June 30,</b>		Affected Line Item in the Consolidated Statements of Income
	<b>2016</b>	<b>2015</b>	
<b>Securities available for sale:</b>			
Net securities (gains) losses reclassified into earnings	\$ (6)	\$ 52	Net gains (losses) on calls and sales of securities available for sale
Related income tax expense (benefit)	2	(18)	Income tax expense
<b>Total reclassifications</b>	<b>\$ (4)</b>	<b>\$ 34</b>	Net of tax

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 16. Acquisition**

On April 17, 2015, the Bank completed its acquisition of six branch banking operations located in Virginia from Bank of America, National Association (the Acquisition). The Bank paid cash of \$6.6 million for the deposits and premises and equipment. The Bank acquired all related premises and equipment valued at \$4.5 million and assumed \$186.8 million of deposit liabilities. No loans were acquired in the transaction.

The transaction was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration exchanged were recorded at estimated fair values on the acquisition date. The Bank engaged third party specialists to assist in valuing certain assets, including the real estate, core deposit intangible, and goodwill (bargain purchase gain) that resulted from the Acquisition.

The following table provides a preliminary assessment of the consideration transferred, assets purchased, and the liabilities assumed (in thousands):

	As Recorded by Bank of America	Fair Value and Other Merger Related Adjustments	As Recorded by the Company
<b>Consideration paid:</b>			
Cash paid			\$ 6,618
Total consideration			\$ 6,618
<b>Assets acquired:</b>			
Cash and cash equivalents	\$ 186,119	\$	\$ 186,119
Premises and equipment, net	2,165	2,330	4,495
Other assets	114		114
Core deposit intangibles		2,910	2,910
Total assets acquired	\$ 188,398	\$ 5,240	\$ 193,638
<b>Liabilities assumed:</b>			
Deposits	\$ 186,119	\$ 683	\$ 186,802
Other liabilities	17		17
Total liabilities assumed	\$ 186,136	\$ 683	\$ 186,819
	\$ 2,262	\$ 4,557	\$ 6,819

**Net identifiable assets acquired over liabilities assumed**

<b>Goodwill (bargain purchase gain)</b>	<b>\$ (201)</b>
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The bargain purchase gain from the transaction may have resulted from Bank of America's decision to no longer operate bank branches in certain markets and their willingness to sell the related premises and equipment lower than fair value.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Cautionary Statement Regarding Forward-Looking Statements**

The Company makes forward-looking statements in this Form 10-Q that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, 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," "forecasts," "intends," or other similar words 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;

the Company's inability to successfully obtain the expected benefits of the acquisition of bank branches;

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 of the Company's Form 10-K for the year ending December 31, 2015.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition at June 30, 2016 and statements of income of the Company for the three and six month periods ended June 30, 2016 and 2015 should be read in conjunction with the consolidated financial statements and related notes included in Part I, Item 1, of this Form 10-Q and in Part II, Item 8, of the Form 10-K for the period ending December 31, 2015. The statements of income for the three and six month periods ended June 30, 2016 may not be indicative of the results to be achieved for the year.

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### **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 and are not included in the Company's consolidated financial statements because management has determined that the Trusts qualify as variable interest entities.

#### Debt Issuance and Preferred Stock Redemption

During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 pursuant to which the Company issued an interest only subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum with a maturity date of October 1, 2025. On November 6, 2015, the Company used the proceeds from the dividends and from the issuance of the Note to redeem all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A, totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B, totaling \$695 thousand.

#### Acquisition of Branches

On April 17, 2015, the Bank expanded its branch network in the Shenandoah Valley and central Virginia regions through the acquisition of six bank branches from Bank of America, National Association located in Woodstock, Staunton, Elkton, Waynesboro, Farmville and Dillwyn, Virginia (the Acquisition). The Acquisition included the purchase of \$4.5 million of premises and equipment and the assumption of \$186.8 million of deposit liabilities. No loans were purchased in the transaction. Upon completion of the Acquisition, the Bank hired all 36 of the employees working at the six acquired branches. During second quarter of 2015, the Bank also hired a regional president and appointed two market executives in the new markets. As a result of the transaction, the Bank increased the number of bank branch locations from 10 to 16, in addition to its existing loan production office in the city of Harrisonburg, Virginia, and its customer service center located in a retirement community in Winchester, Virginia.



Products, Services, Customers and Locations

The Bank provides loan, deposit, wealth management and other products and services in the Shenandoah Valley and central regions of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, money market accounts, individual retirement accounts, certificates of deposit and cash management accounts.

The Bank's wealth management department offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. The Bank's mortgage department originates residential mortgage loans to customers. Loans originated through this department may be sold to investors in the secondary market or held in the Bank's loan portfolio. Mortgage services are offered to customers throughout the Bank's market area.

The Bank's office locations are well-positioned in attractive markets along the Interstate 81, Interstate 66 and Interstate 64 corridors in the Shenandoah Valley and central regions of Virginia. Within this 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.

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The Bank's products and services are delivered through its mobile banking platform, its website, [www.fbvirginia.com](http://www.fbvirginia.com), a network of ATMs located throughout its market area, two loan production offices, a customer service center in a retirement village, and 14 bank branch office locations located throughout the Shenandoah Valley and central regions of Virginia. The branch offices are comprised of 13 full service retail banking offices and one drive-thru express banking office. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2015.

## 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.

Primary expense categories are salaries and employee benefits, which comprised 57% of noninterest expenses for the six month period ended June 30, 2016, followed by occupancy and equipment expense, which comprised 13% of noninterest expenses. Historically, the provision for loan losses has also been a primary expense of the Bank. 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.

## Quarterly Performance

For the three months ended June 30, 2016, net income available to common shareholders totaled \$1.4 million, or \$0.29 per basic and diluted share, compared to \$116 thousand, or \$0.02 per basic and diluted share, for the same period in 2015. Return on average assets and return on average equity were 0.82% and 11.90%, respectively, for the second quarter of 2016 compared to 0.27% and 2.97%, respectively, for the same quarter in 2015. Net income available to common shareholders for the second quarter of 2015 was negatively impacted by integration expenses of \$458 thousand related to the Acquisition and the effective dividend on preferred stock of \$328 thousand. The integration expenses primarily included legal and professional fees, supplies expense, data processing expense, and postage expense.

Net interest income increased 14%, or \$728 thousand to \$5.8 million for the quarter ended June 30, 2016, compared to \$5.1 million for the second quarter of 2015. The net interest margin was 3.62% for the second quarter of 2016 compared to 3.29% for the same period in 2015. The increase in net interest income was primarily the result of higher balances of average earning assets, in addition to a change in the mix of average earning assets, as loan and securities balances increased and interest-bearing deposits in banks decreased when comparing the periods.

Noninterest income decreased \$197 thousand, or 9%, to \$2.1 million compared to \$2.3 million for the second quarter of 2015. The decrease in noninterest income was primarily attributable to a \$201 thousand bargain purchase gain recorded in 2015, which resulted from the Acquisition.

Noninterest expense decreased \$972 thousand, or 14%, to \$5.9 million for the quarter compared to \$6.9 million for the same period in 2015. The decrease in expenses was primarily attributable to lower salaries and employee benefits

expense, lower other operating expense, income recognized on sales of other real estate owned, and integration expenses from the Acquisition which were incurred during the second quarter of 2015.

The Bank did not record a provision for (or recovery of) loan losses during the second quarter of 2016 compared to a \$100 thousand recovery of loan losses recorded during the same period of 2015. For a more detailed discussion of the Bank's provision for (or recovery of) loan losses, see [Provision for \(Recovery of\) Loan Losses](#) below.

**Table of Contents****Year-to-Date Performance**

Net income available to common shareholders totaled \$2.5 million, or \$0.51 per basic and diluted share, for the six months ended June 30, 2016 compared to \$331 thousand, or \$0.07 per basic and diluted share, for the same period in 2015. Return on average assets and return on average equity were 0.73% and 10.66%, respectively, for the six months ended June 30, 2016 compared to 0.34% and 3.32% for the same period in 2015.

For the six months ended June 30, 2016, net interest income increased 19%, or \$1.8 million, compared to the same period of 2015. The increase was primarily attributable to higher average balances of loans and securities. The net interest margin was 3.62% for the six months ended June 30, 2016 compared to 3.58% for the same period in 2015. The Bank did not record a provision for (or recovery of) loan losses during the six month period ended June 30, 2016, compared to a recovery of loan losses of \$100 thousand for the same period one year ago. Noninterest income increased \$155 thousand, or 4%, to \$4.1 million compared to \$3.9 million when comparing the two periods. Noninterest expense decreased \$342 thousand, or 3%, to \$12.0 million compared to \$12.3 million for the same period in 2015.

**Non-GAAP Financial Measures**

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO income/(expense), amortization of intangibles, and acquisition and integration related expenses, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities (gains)/losses and bargain purchase gain. 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 following table (dollars in thousands).

	<b>Efficiency Ratio</b>			
	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Noninterest expense	\$ 5,883	\$ 6,855	\$ 12,000	\$ 12,342
Add/(Subtract): other real estate owned income/(expense), net	49	(152)	121	(116)
Subtract: amortization of intangibles	(198)	(196)	(405)	(200)
Subtract: acquisition and integration related expenses		(458)		(877)
	\$ 5,734	\$ 6,049	\$ 11,716	\$ 11,149
Tax-equivalent net interest income	\$ 5,894	\$ 5,135	\$ 11,694	\$ 9,826
Noninterest income	2,112	2,309	4,055	3,900
Add/(Subtract): securities (gains)/losses, net			(6)	52
Subtract: bargain purchase gain		(201)		(201)

\$ 8,006	\$ 7,243	\$ 15,743	\$ 13,577
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Efficiency ratio	71.62%	83.52%	74.42%	82.12%
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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 both 2016 and 2015 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).

**Table of Contents****Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income**

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
<b>GAAP measures:</b>				
Interest income - loans	\$ 5,370	\$ 4,688	\$ 10,606	\$ 9,228
Interest income - investments and other	908	704	1,863	1,152
Interest expense - deposits	(329)	(266)	(662)	(566)
Interest expense - other borrowings		(2)	(5)	(3)
Interest expense - subordinated debt	(89)		(179)	
Interest expense - junior subordinated debt	(64)	(55)	(125)	(109)
Interest expense - federal funds purchased		(1)	(3)	(2)
<b>Total net interest income</b>	<b>\$ 5,796</b>	<b>\$ 5,068</b>	<b>\$ 11,495</b>	<b>\$ 9,700</b>
<b>Non-GAAP measures:</b>				
Tax benefit realized on non-taxable interest income - loans	\$ 25	\$ 27	\$ 50	\$ 53
Tax benefit realized on non-taxable interest income - municipal securities	73	40	149	73
<b>Total tax benefit realized on non-taxable interest income</b>	<b>\$ 98</b>	<b>\$ 67</b>	<b>\$ 199</b>	<b>\$ 126</b>
<b>Total tax-equivalent net interest income</b>	<b>\$ 5,894</b>	<b>\$ 5,135</b>	<b>\$ 11,694</b>	<b>\$ 9,826</b>

**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 losses 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.

Presented below is a discussion of those accounting policies that management believes are the most important ( Critical Accounting Policies ) to the portrayal and understanding of the Company's financial condition and results of operations. The Critical Accounting Policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for (or recovery of) 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-Q.

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, 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.

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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 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.

Commercial and industrial loans carry risks associated with the successful operation of a business because repayment of these loans may be dependent upon the profitability and cash flows of the business. 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 creditworthiness 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.

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, fair value of collateral less estimated costs to sell 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 Note 4 to the Consolidated Financial Statements.

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### **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 initially recorded at fair value less estimated costs to sell to establish a new cost basis. OREO is subsequently 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 owned 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 (income) expense.

### **Business Combinations**

Business combinations are accounted for under ASC 805, *Business Combinations*, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company relies on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. The determination of fair values requires management to make estimates about future cash flows, market conditions and other events, which are highly subjective in nature. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are incremental costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of acquisition-related costs to the Company include system conversions, integration planning consultants, and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received. The costs to issue debt or equity securities will be recognized in accordance with other applicable U.S. GAAP. These acquisition-related costs are included within the Consolidated Statements of Income classified within the noninterest expense caption.

### **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 four directors, three

of which are non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews risk management reports, including watch list reports and concentrations of credit. 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 mortgage 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 June 30, 2016, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$73.7 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 borrower's 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 be appraised with as much reliability as residential real estate.

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### **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, subordinated debt and junior subordinated debt. 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 (or recovery of) 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 income or expense.

#### **Net Interest Income**

Net interest income increased 14%, or \$728 thousand to \$5.8 million for the quarter ended June 30, 2016, compared to \$5.1 million for the second quarter of 2015. This increase resulted from larger average balances of loans and securities, when comparing the periods. The growth in average loans and securities was primarily attributable to a change in the earning asset mix as cash received from the Acquisition has been deployed into loans and securities. The majority of the cash received in the Acquisition was initially invested in interest-bearing deposits in banks, which is a lower-yielding asset when compared to loans and securities. The net interest margin was 3.62% for the second quarter of 2016 compared to 3.29% for the same period in 2015.

The net interest margin increased 33 basis points to 3.62%, compared to 3.29% for the second quarter of 2015. The increase resulted from a 42 basis point increase in the total earning asset yield. The increase in the total earning asset yield was primarily a result of a change in the composition of average earning assets. Average securities increased from 19% of average earning assets for the three month period ended June 30, 2015 to 24% for the three month period

ended June 30, 2016 and average loans increased from 63% to 70% of average earning assets. While loans and securities balances increased, average interest-bearing deposits in banks decreased from 18% to 6% of average earning assets, when comparing the periods. The change in the mix of earning assets had a favorable impact on net interest income as loans and securities were higher-yielding assets when compared to interest-bearing deposits in banks.

For the six months ended June 30, 2016, net interest income totaled \$11.5 million, which was a 19% increase when compared to the same period a year ago. The net interest margin increased to 3.62% from 3.58% and average earning assets were \$95.7 million higher when comparing the periods. Interest-earning asset yields increased 10 basis points while interest expense as a percent of average earning assets increased 5 basis points. For the six month period, interest-earning asset yields increased due to the changes in the earning asset mix, and interest expense as a percent of average earning assets increased primarily due to the addition of subordinated debt during the fourth quarter of 2015.

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The following tables show interest income on earning assets and related average yields as well as interest expense on interest-bearing liabilities and related average rates paid for the periods indicated (dollars in thousands):

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

	For the three months ended					
	June 30, 2016			June 30, 2015		
	Average Balance	Interest Expense	Income/ Yield/ Rate	Average Balance	Interest Expense	Income/ Yield/ Rate
<b>Assets</b>						
Securities:						
Taxable	\$ 133,517	\$ 683	2.06%	\$ 106,448	\$ 540	2.03%
Tax-exempt <sup>(1)</sup>	24,154	215	3.60%	12,781	118	3.71%
Restricted	1,559	21	5.45%	1,497	18	4.97%
Total securities	\$ 159,230	\$ 919	2.32%	\$ 120,726	\$ 676	2.25%
Loans: <sup>(2)</sup>						
Taxable	\$ 450,878	\$ 5,321	4.75%	\$ 387,219	\$ 4,637	4.80%
Tax-exempt <sup>(1)</sup>	6,847	74	4.33%	7,194	78	4.33%
Total loans	\$ 457,725	\$ 5,395	4.74%	\$ 394,413	\$ 4,715	4.79%
Interest-bearing deposits with other institutions	37,580	62	0.66%	110,058	68	0.25%
Total earning assets	\$ 654,535	\$ 6,376	3.92%	\$ 625,197	\$ 5,459	3.50%
Less: allowance for loan losses	(5,548)			(6,698)		
Total non-earning assets	56,720			52,700		
Total assets	\$ 705,707			\$ 671,199		
<b>Liabilities and Shareholders Equity</b>						
Interest bearing deposits:						
Checking	\$ 152,140	\$ 92	0.24%	\$ 140,007	\$ 45	0.13%
Regular savings	125,487	26	0.08%	115,763	24	0.08%
Money market accounts	61,884	26	0.17%	49,026	15	0.12%
Time deposits:						
\$100,000 and over	45,313	89	0.79%	51,723	115	0.89%
Under \$100,000	88,891	95	0.43%	89,559	67	0.30%
Brokered	601	1	0.45%	600		
Total interest-bearing deposits	\$ 474,316	\$ 329	0.28%	\$ 446,678	\$ 266	0.24%
Federal funds purchased	3			385	1	0.64%
Subordinated debt	4,919	89	7.33%			
Junior subordinated debt	9,279	64	2.75%	9,279	55	2.39%
Other borrowings	242			2,654	2	0.28%



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Total interest-bearing liabilities	\$ 488,759	\$ 482	0.40%	\$ 458,996	\$ 324	0.28%
Non-interest bearing liabilities						
Demand deposits	162,486			146,762		
Other liabilities	6,019			5,484		
Total liabilities	\$ 657,264			\$ 611,242		
Shareholders equity	48,443			59,957		
Total liabilities and Shareholders equity	\$ 705,707			\$ 671,199		
Net interest income		\$ 5,894			\$ 5,135	
Interest rate spread			3.52%			3.22%
Cost of funds			0.30%			0.21%
Interest expense as a percent of average earning assets			0.30%			0.21%
Net interest margin			3.62%			3.29%

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$98 thousand and \$67 thousand for the three months ended June 30, 2016 and 2015, respectively.
- (2) Loans placed on a non-accrual status are reflected in the balances.

**Table of Contents****Average Balances, Income and Expenses, Yields and Rates (Taxable Equivalent Basis)**

	For the six months ended					
	June 30, 2016			June 30, 2015		
	Average Balance	Interest Expense	Income/ Yield/ Rate	Average Balance	Interest Expense	Income/ Yield/ Rate
<b>Assets</b>						
Securities:						
Taxable	\$ 138,221	\$ 1,424	2.07%	\$ 90,779	\$ 898	1.99%
Tax-exempt <sup>(1)</sup>	24,651	438	3.58%	11,288	215	3.83%
Restricted	1,570	40	5.09%	1,479	39	5.36%
Total securities	\$ 164,442	\$ 1,902	2.33%	\$ 103,546	\$ 1,152	2.24%
Loans: <sup>(2)</sup>						
Taxable	\$ 445,205	\$ 10,508	4.75%	\$ 382,598	\$ 9,126	4.81%
Tax-exempt <sup>(1)</sup>	6,880	148	4.33%	7,181	155	4.35%
Total loans	\$ 452,085	\$ 10,656	4.74%	\$ 389,779	\$ 9,281	4.80%
Federal funds sold	1			2		
Interest-bearing deposits with other institutions	32,418	110	0.68%	59,916	73	0.25%
Total earning assets	\$ 648,946	\$ 12,668	3.93%	\$ 553,243	\$ 10,506	3.83%
Less: allowance for loan losses	(5,536)			(6,729)		
Total non-earning assets	56,326			47,585		
Total assets	\$ 699,736			\$ 594,099		
<b>Liabilities and Shareholders Equity</b>						
Interest bearing deposits:						
Checking	\$ 148,829	\$ 177	0.24%	\$ 124,737	\$ 86	0.14%
Regular savings	124,761	52	0.08%	109,818	46	0.08%
Money market accounts	60,164	50	0.17%	35,648	24	0.14%
Time deposits:						
\$100,000 and over	46,913	197	0.84%	48,151	240	1.01%
Under \$100,000	89,659	185	0.42%	71,469	167	0.47%
Brokered	601	1	0.45%	937	3	0.54%
Total interest-bearing deposits	\$ 470,927	\$ 662	0.28%	\$ 390,760	\$ 566	0.29%
Federal funds purchased	673	3	1.03%	421	2	0.72%
Subordinated debt	4,917	179	7.33%			
Junior subordinated debt	9,279	125	2.71%	9,279	109	2.38%
Other borrowings	2,236	5	0.44%	2,434	3	0.27%
Total interest-bearing liabilities	\$ 488,032	\$ 974	0.40%	\$ 402,894	\$ 680	0.34%
Non-interest bearing liabilities						

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Demand deposits	158,108	126,196
Other liabilities	5,834	5,055
<b>Total liabilities</b>	<b>\$ 651,974</b>	<b>\$ 534,145</b>
Shareholders' equity	47,762	59,954
<b>Total liabilities and Shareholders' equity</b>	<b>\$ 699,736</b>	<b>\$ 594,099</b>
Net interest income	\$ 11,694	\$ 9,826
Interest rate spread	3.53%	3.49%
Cost of funds	0.30%	0.26%
Interest expense as a percent of average earning assets	0.30%	0.25%
Net interest margin	3.62%	3.58%

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$199 thousand and \$126 thousand for the six months ended June 30, 2016 and 2015, respectively.
- (2) Loans placed on a non-accrual status are reflected in the balances.

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**Table of Contents****Provision for (Recovery of) Loan Losses**

The Bank did not record a provision for (or recovery of) loan losses during the second quarter of 2016, which resulted in a total allowance for loan losses of \$5.7 million, or 1.23% of total loans, at June 30, 2016. This compared to a recovery of loan losses of \$100 thousand and an allowance for loan losses of \$6.1 million, or 1.56% of total loans, at the end of the same quarter in 2015. The Bank did not record a provision for (or recovery of) loan losses during the quarter as the specific reserve requirement of the allowance for loan losses decreased and the Bank experienced net recoveries of loans charged-off in prior periods. The decrease in the specific reserve component of the allowance for loan losses was offset by the increase in the general reserve component during the quarter, which was primarily due to growth in the loan portfolio. The decrease in the specific reserve was a result of improvements in collateral positions of impaired loans. Net recoveries totaled \$214 thousand for the second quarter of 2016 compared to \$542 thousand of net charge-offs for the same period in 2015.

For the six months ended June 30, 2016, the Bank did not record a provision for (or recovery of) loan losses, compared to recovery of loan losses of \$100 thousand for the same period in 2015. The recovery of loan losses in 2015 was primarily the result of a decrease in the general component of the allowance for loan losses, which resulted from loan balances that decreased during the second quarter of 2015, increased collateral values on residential real estate properties, and improved asset quality during the period. Net recoveries totaled \$210 thousand for the six months ended June 30, 2016 compared to net charge-offs of \$489 thousand for the same period in 2015.

**Noninterest Income**

Noninterest income decreased 9% to \$2.1 million for the quarter ended June 30, 2016 from \$2.3 million for the same period in 2015. Revenue categories that decreased during the second quarter of 2016 compared to the same period one year ago included wealth management fees and bargain purchase gain. The decrease in wealth management fees was attributable to the elimination of brokerage services at the beginning of 2016. The bargain purchase gain recorded in 2015 resulted from the Acquisition. These decreases were partially offset by a \$162 thousand, or 22% increase in service charges on deposits. The increase in service charges on deposits was primarily attributable to the Acquisition and the related increase in deposit balances.

For the six months ended June 30, 2016, noninterest income increased \$155 thousand, or 4%, to \$4.1 million compared to \$3.9 million for the same period one year ago. Revenue categories that increased during the six month period ended June 30, 2016 compared to the same period one year ago included service charges on deposits, ATM and check card fees, and other operating income. The increases in service charges on deposits and ATM and check card fees were primarily attributable to the Acquisition and the related increase in deposit balances. The increase in other operating income resulted primarily from revenue that resulted from a three-year agreement not to compete with former employees, which was related to the elimination of brokerage services on January 1, 2016. Noninterest income also increased when comparing the periods from net gains on sales and calls of securities of \$6 thousand in the first quarter of 2016 compared to net losses on sales and calls of securities of \$52 thousand for the first quarter of 2015. These increases were partially offset by a \$332 thousand, or 33% decrease in wealth management fees and the \$201 thousand decrease in bargain purchase gain from the Acquisition. The decrease in wealth management fees was attributable to the elimination of brokerage services referred to above.

**Noninterest Expense**

Noninterest expense decreased \$972 thousand, or 14%, to \$5.9 million for the quarter compared to \$6.9 million for the same quarter of 2015. The decrease in noninterest expense was primarily due to a \$182 thousand, or 5% decrease in expenses related to salaries and employee benefits, a \$126 thousand decrease in supplies expense, a \$275 thousand

decrease in legal and professional fees, an \$80 thousand decrease in data processing expense, and a \$201 thousand decrease in net other real estate owned expense, when comparing the periods.

Salaries and employee benefits decreased primarily from a decrease in the number of employees compared to the second quarter of 2015. The decreases in supplies expense, legal and professional fees, and data processing expense resulted primarily from integration expenses incurred during the second quarter of 2015 related to the Acquisition, which totaled \$67 thousand, \$230 thousand, and \$72 thousand for these categories, respectively. Total integration expenses related to the Acquisition were \$458 thousand for the three months ended June 30, 2015. Decreases in expenses related to other real estate owned resulted primarily from increased gains on the sale of OREO property and lower write-downs in the carrying value of OREO property, when comparing the periods. These decreases were partially offset by a \$62 thousand increase in FDIC assessment expenses due to higher assessment and growth following the Acquisition.

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For the six months ended June 30, 2016, noninterest expense decreased \$342 thousand, or 3%, to \$12.0 million compared to \$12.3 million for the same period in the prior year. The decrease in noninterest expense was primarily due to a \$370 thousand decrease in supplies expense, a \$176 thousand decrease in legal and professional fees, a \$139 thousand decrease in data processing expense, a \$71 thousand decrease in postage expense, and a \$237 thousand decrease in net other real estate owned expense, when comparing the periods. The decreases in supplies expense, legal and professional fees, data processing expense, and postage expense resulted primarily from integration expenses incurred during the first six months of 2015 related to the Acquisition, which totaled \$325 thousand, \$238 thousand, \$134 thousand, and \$70 thousand for these categories, respectively. Total integration expenses related to the Acquisition were \$877 thousand for the six months ended June 30, 2015. Decreases in expenses related to other real estate owned resulted primarily from increased gains on the sale of OREO property and lower write-downs in the carrying value of OREO property, when comparing the periods.

The decreases described in the paragraph above were partially offset by a \$137 thousand, or 2% increase in expenses related to salaries and employee benefits, a \$133 thousand, or 20% increase in occupancy expense, a \$123 thousand, or 17% increase in equipment expense, an \$81 thousand, or 23% increase in ATM and check card fees, a \$117 thousand, or 89% increase in FDIC assessment expenses, and a \$205 thousand increase in amortization expense. The increases in these categories resulted primarily from the impact of the Acquisition, which increased the number of banking locations and customer deposit balances for a full six month period during 2016, compared to only part of the same period in 2015.

**Income Taxes**

The Company's income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the three and six month periods ended June 30, 2016 and 2015. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income. A more detailed discussion of the Company's tax calculation is contained in Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

**Financial Condition****General**

Total assets increased by \$19.0 million to \$711.3 million at June 30, 2016 compared to \$692.3 million at December 31, 2015. The increase was primarily attributable to a \$26.3 million increase in net loans and a \$9.1 million increase in interest-bearing deposits in banks, when comparing the periods. The increases in net loans and interest-bearing deposits in banks were partially offset by a \$19.4 million decrease in securities since December 31, 2015.

**Loans**

Loans, net of the allowance for loan losses, increased \$26.3 million, or 6% to \$459.8 million at June 30, 2016, compared to \$433.5 million at December 31, 2015. Growth of the loan portfolio was led by other real estate loans with balances that increased \$18.7 million during the first six months of 2016, followed by residential real estate loans with balances that increased by \$7.0 million.

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The Bank segments its loan portfolio into real estate loans, commercial and industrial loans, and consumer and other loans. Real estate loans are further divided into the following classes: Construction and Land Development; 1-4

Family Residential; and Other Real Estate Loans. Descriptions of the Company's loan classes are as follows:

**Real Estate Loans – Construction and Land Development:** The Company originates construction loans for the acquisition and development of land and construction of condominiums, townhomes, and one-to-four family residences.

**Real Estate Loans – 1-4 Family:** This class of loans includes loans secured by one-to-four family homes. In addition to traditional residential mortgage loans secured by a first or junior lien on the property, the Bank offers home equity lines of credit.

**Real Estate Loans – Other:** This loan class consists primarily of loans secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches.

**Commercial and Industrial Loans:** Commercial loans are typically secured with non-real estate commercial property. The Company makes commercial loans primarily to businesses located within its market area.

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**Consumer and Other Loans:** Consumer loans include all loans made to individuals for consumer or personal purposes. They include new and used automobile loans, unsecured loans and lines of credit.

A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate throughout the Shenandoah Valley region of Virginia. The ability of the Bank's debtors to honor their contracts may be impacted by the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances less the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued and credited to income based on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

A loan's past due status is based on the contractual due date of the most delinquent payment due. Loans are generally placed on non-accrual status when the collection of principal or interest is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Loans greater than 90 days past due may remain on accrual status if management determines it has adequate collateral to cover the principal and interest. Loans greater than 90 days past due and still accruing totaled \$11 thousand at June 30, 2016, compared to \$92 thousand at December 31, 2015. For those loans that are carried on non-accrual status, payments are first applied to principal outstanding. A loan may be returned to accrual status if the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms of the loan and there is reasonable assurance the borrower will continue to make payments as agreed. These policies are applied consistently across the loan portfolio.

All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Any unsecured loan that is deemed uncollectible is charged-off in full. Any secured loan that is considered by management to be uncollectible is partially charged-off and carried at the fair value of the collateral less estimated selling costs. This charge-off policy applies to all loan segments.

## Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Additionally, management generally evaluates substandard and doubtful loans greater than \$250 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company typically does not



separately identify individual consumer, residential and certain small commercial loans that are less than \$250 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below. The recorded investment in impaired loans totaled \$7.4 million and \$7.7 million at June 30, 2016 and December 31, 2015, respectively.

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**Table of Contents****Troubled Debt Restructurings (TDR)**

In situations where, for economic or legal reasons related to a borrower's financial condition, management grants a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower's payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on non-accrual status at the time of the TDR, the loan will remain on non-accrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above. There were \$660 thousand and \$982 thousand in loans classified as TDRs as of June 30, 2016 and December 31, 2015, respectively.

**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 when its customers do not meet the contractual obligation of their loans, 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 \$442 thousand at June 30, 2016 and \$2.7 million at December 31, 2015. The valuation allowance for other real estate owned totaled \$181 thousand and \$224 thousand at June 30, 2016 and December 31, 2015, respectively.

Non-performing assets were \$4.5 million at June 30, 2016 and \$6.5 million at December 31, 2015, representing 0.63% and 0.94% of total assets, respectively. Non-performing assets included \$4.1 million in non-accrual loans and \$442 thousand in OREO, net of the valuation allowance at June 30, 2016. This compares to \$3.9 million in non-accrual loans and \$2.7 million in OREO, net of the valuation allowance at December 31, 2015.

The levels of non-performing assets at June 30, 2016 and December 31, 2015 were primarily attributable to business customers involved in commercial real estate and construction and land development that have not been able to meet their debt requirements because they have not fully recovered from the recent recession. At June 30, 2016, 56% of non-performing assets related to commercial real estate loans, 34% related to construction and land development loans, 8% related to residential real estate loans, and 2% 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 \$9.6 million and \$10.3 million at June 30, 2016 and December 31, 2015, 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.

Loans greater than 90 days past due and still accruing totaled \$11 thousand at June 30, 2016, which was comprised of two small loans expected to pay all principal and interest amounts contractually due to the Bank. There were \$92 thousand of loans greater than 90 days past due and still accruing at December 31, 2015.

The allowance for 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 current estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan

losses totaled \$5.7 million at June 30, 2016 and \$5.5 million at December 31, 2015, representing 1.23% and 1.26% of total loans, respectively. Although total loans increased by \$26.5 million during the six months ended June 30, 2016, no provision for loan loss was required as the Bank experienced net recoveries of \$210 thousand during the period and a decrease in the specific reserve requirement of the allowance for loan losses as a result of improvements in collateral positions of impaired loans in the specific allocation. Recoveries of loan losses of \$865 thousand and \$178 thousand were experienced in the Construction and Land Development and 1-4 Family Residential loan classes, respectively, during the six month period ended June 30, 2016. The recovery of loan losses in the Construction and Land Development loan class was primarily attributable to decreases in the specific reserve and decreases in the general allocation from improvements in the historical loss experience. The recoveries of loan losses in the 1-4 Family Residential loan class resulted from net recoveries of loans charged-off in prior periods. These recoveries were offset by provision for loan losses experienced in the Other Real Estate, Commercial and Industrial, and Consumer and Other loan classes, which resulted primarily from increases in the general reserve requirement due to growth in the loan portfolio.

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Impaired loans totaled \$7.4 million and \$7.7 million at June 30, 2016 and December 31, 2015, respectively. The related allowance for loan losses provided for these loans totaled \$184 and \$544 thousand at June 30, 2016 and December 31, 2015, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2016 and the year ended December 31, 2015 was \$7.7 million and \$10.5 million, respectively. Included in the impaired loans total at June 30, 2016 was one loan classified as a TDR totaling \$660 thousand. Loans classified as TDRs represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of June 30, 2016, the loan classified as a TDR was not performing under the restructured terms and was considered a non-performing asset.

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 (or recovery of) loan losses charged to (income) or 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 (or recovery of) 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.

**Securities**

The securities portfolio plays a primary role in the management of the Company's interest rate sensitivity and serves as a source of liquidity. The portfolio is used as needed to meet collateral requirements, such as those related to secure public deposits and balances with the Reserve Bank. The investment portfolio consists of held to maturity, available for sale, and restricted securities. Securities are classified as available for sale or held to maturity based on the Company's investment strategy and management's assessment of the intent and ability to hold the securities until maturity. Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold the investment securities to maturity, they are classified as investment securities held to maturity and are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts using the interest method. Investment securities which the Company may not hold to maturity are classified as investment securities available for sale, as management has the intent and ability to hold such investment securities for an indefinite period of time, but not necessarily to maturity. Securities available for sale may be sold in response to changes in market interest rates, changes in prepayment risk, increases in loan demand, general liquidity needs and other similar factors and are carried at estimated fair value. Restricted securities, including Federal Home Loan Bank, Federal Reserve Bank, and Community Bankers' Bank stock, are generally viewed as long-term investments because there is minimal market for the stock and are carried at cost.

Securities at June 30, 2016 totaled \$154.0 million, a decrease of \$19.4 million or 11% from \$173.5 million at December 31, 2015. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. As of June 30, 2015, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios. Gross unrealized gains in the available for sale portfolio totaled \$1.3 million and \$601 thousand at June 30, 2016 and December 31, 2015, respectively. Gross unrealized losses in the available for sale portfolio totaled \$127 thousand and \$893 thousand at June 30, 2016 and December 31, 2015, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$993 thousand and \$264 thousand at June 30, 2016 and December 31, 2015, respectively. Gross unrealized losses in the held to maturity portfolio totaled \$19 thousand and \$345 thousand at June 30, 2016 and December 31, 2015, respectively. Investments in an unrealized loss position were considered temporarily impaired at June 30, 2016 and

December 31, 2015. The change in the unrealized gains and losses of investment securities from December 31, 2015 to June 30, 2016 was related to changes in market interest rates.

### Deposits

At June 30, 2016, deposits totaled \$630.3 million, an increase of \$3.2 million, from \$627.1 million at December 31, 2015. There was not a significant change in the deposit mix when comparing the periods. At June 30, 2016, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 25%, 54%, and 21% of total deposits, respectively, compared to 25%, 52%, and 23% at December 31, 2015.

### 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.

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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.

At June 30, 2016, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$118.3 million. At June 30, 2016, 14% or \$65.9 million of the loan portfolio matures within one year. Non-deposit sources of available funds totaled \$118.6 million at June 30, 2016, which included \$74.5 million available from Federal Home Loan Bank of Atlanta (FHLB), \$42.0 million of unsecured federal funds lines of credit with other correspondent banks and \$2.1 million available through the Federal Reserve Discount Window.

**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 Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital.

In July 2013, the U.S. banking regulators adopted a final rule which implements the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision, and certain changes required by the Dodd-Frank Act. The final rule established an integrated regulatory capital framework and introduces the Standardized Approach for risk-weighted assets, which replaced the Basel I risk-based guidance for determining risk-weighted assets as of January 1, 2015, the date the Bank became subject to the new rules. Based on the Bank's current capital composition and levels, the Bank believes it is in compliance with the requirements as set forth in the final rules.

The rules included new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019, and refined the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Bank under the final rules were as follows: a new common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6% (increased from 4%); a total capital ratio of 8% (unchanged from previous rules); and a Tier 1 leverage ratio of 4% for all institutions. The final rules also established a capital conservation buffer above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: a common equity Tier 1 capital ratio of 7.0%, a Tier 1 capital ratio of 8.5%, and a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions. Management believes, as of June 30, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

The following table shows the Bank's regulatory capital ratios at June 30, 2016:

	First Bank
Total capital to risk-weighted assets	13.66%

Tier 1 capital to risk-weighted assets	12.45%
Common equity Tier 1 capital to risk-weighted assets	12.45%
Tier 1 capital to average assets	8.33%
Capital conservation buffer ratio <sup>(1)</sup>	5.66%

(1) Calculated by subtracting the regulatory minimum capital ratio requirements from the Company's actual ratio for Common equity Tier 1, Tier 1, and Total risk based capital. The lowest of the three measures represents the Bank's capital conservation buffer ratio.

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are now required to meet the following increased capital level requirements in order to qualify as well capitalized: a new common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8% (increased from 6%); a total capital ratio of 10% (unchanged from previous rules); and a Tier 1 leverage ratio of 5% (unchanged from previous rules).

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On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B totaling \$695 thousand. While the preferred stock was outstanding, the Company's Series A Preferred Stock paid a dividend of 5% per annum until May 14, 2014 and 9% thereafter, and the Series B Preferred Stock which paid a dividend of 9% per annum.

During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 to which the Company issued a subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note is intended to qualify as Tier 2 capital for regulatory capital purposes. The Note has a maturity date of October 1, 2025. The Company used the proceeds from the dividends and from the issuance of the Note to redeem all outstanding preferred stock.

## Contractual Obligations

There have been no material changes outside the ordinary course of business to the contractual obligations disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

## Off-Balance Sheet Arrangements

The Company, through the Bank, is a party to credit related financial instruments with risk not reflected in the consolidated financial statements in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance sheet instruments.

Commitments to extend credit, which amounted to \$61.3 million at June 30, 2016, and \$61.1 million at December 31, 2015, 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.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At June 30, 2016 and December 31, 2015, the Bank had \$8.8 million and \$7.7 million in outstanding standby letters of credit, respectively.



At June 30, 2016, the Bank had \$3.6 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.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not required.

**Item 4. Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods required by the SEC and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow

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timely decisions regarding required disclosure. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2016 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

There are no material pending legal proceedings, other than ordinary routine litigation incidental to the Company's business, to which the Company is a party or to which the property of the Company is subject.

**Item 1A. Risk Factors**

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2015.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification

- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
- 101 The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (Loss) (iv) Consolidated Statements of Cash Flows, (v) Consolidated Statements of Shareholders' Equity, and (vi) Notes to Consolidated Financial Statements.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**FIRST NATIONAL CORPORATION**  
(Registrant)

/s/ Scott C. Harvard  
Scott C. Harvard  
President and Chief Executive Officer

August 12, 2016  
Date

/s/ M. Shane Bell  
M. Shane Bell  
Executive Vice President and Chief Financial Officer

August 12, 2016  
Date

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**EXHIBIT INDEX**

Number	Document
31.1	Certification of Chief Executive Officer, Section 302 Certification
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