FIRST NATIONAL CORP /VA/
Form 10-Q
August 14, 2014
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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, 2014

or

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

For the transition period from _____ to _____

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

Virginia	**54-1232965**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
112 West King Street, Strasburg, Virginia	**22657**
(Address of principal executive offices)	**(Zip Code)**

(540) 465-9121

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive 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 x No ¨

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. As of August 14, 2014, 4,902,582 shares of common stock, par value $1.25 per share, of the registrant were outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

(in thousands, except per share data)

	(unaudited) June 30, 2014	December 31, 2013
Assets		
Cash and due from banks	$ 6,587	$ 5,767
Interest-bearing deposits in banks	12,735	25,741
Securities available for sale, at fair value	108,884	103,301
Restricted securities, at cost	1,636	1,804
Loans, net of allowance for loan losses, 2014, $10,006; 2013, $10,644	357,484	346,449
Other real estate owned, net of valuation allowance, 2014, $1,588; 2013, $1,665	2,221	3,030
Premises and equipment, net	16,305	16,642
Accrued interest receivable	1,258	1,302
Bank owned life insurance	11,141	10,978
Other assets	7,072	7,876
Total assets	$ 525,323	$ 522,890
Liabilities and Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 99,396	$ 92,901
Savings and interest-bearing demand deposits	235,929	234,054
Time deposits	115,873	123,756
Total deposits	$ 451,198	$ 450,711
Other borrowings	6,039	6,052
Trust preferred capital notes	9,279	9,279
Accrued interest and other liabilities	2,151	3,288
Total liabilities	$ 468,667	$ 469,330

Shareholders Equity		
Preferred stock, $1,000 per share liquidation preference; authorized 1,000,000 shares; 14,595 shares issued and outstanding, net of discount	$ 14,595	$ 14,564
Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2014, 4,902,582 shares; 2013, 4,901,464 shares	6,128	6,127
Surplus	6,821	6,813
Retained earnings	29,516	27,360
Accumulated other comprehensive loss, net	(404)	(1,304)
Total shareholders equity	$ 56,656	$ 53,560
Total liabilities and shareholders equity	$ 525,323	$ 522,890

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

Three months ended June 30, 2014 and 2013

(in thousands, except per share data)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Interest and Dividend Income		
Interest and fees on loans	$ 4,403	$ 4,816
Interest on deposits in banks	14	17
Interest and dividends on securities available for sale:		
Taxable interest	562	443
Tax-exempt interest	95	76
Dividends	21	19
Total interest and dividend income	$ 5,095	$ 5,371
Interest Expense		
Interest on deposits	$ 372	$ 632
Interest on trust preferred capital notes	54	55
Interest on other borrowings	30	30
Total interest expense	$ 456	$ 717
Net interest income	$ 4,639	$ 4,654
Provision for (recovery of) loan losses	(400)	2,500
Net interest income after provision for (recovery of) loan losses	$ 5,039	$ 2,154
Noninterest Income		
Service charges on deposit accounts	$ 643	$ 464
ATM and check card fees	365	365
Wealth management fees	472	375
Fees for other customer services	126	128
Net gains on sale of loans		65
Net gains on sale of securities available for sale	22	

Other operating income	97	640
Total noninterest income	$ 1,725	$ 2,037
Noninterest Expense		
Salaries and employee benefits	$ 2,554	$ 2,443
Occupancy	278	296
Equipment	295	288
Marketing	126	113
Stationery and supplies	94	81
Legal and professional fees	247	219
ATM and check card fees	163	168
FDIC assessment	122	180
Bank franchise tax	105	70
Other real estate owned, net	(70)	376
Telecommunications	73	78
Data processing	134	95
Loss on disposal of premises and equipment		3
Other operating expense	427	350
Total noninterest expense	$ 4,548	$ 4,760

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

(Continued)

Three months ended June 30, 2014 and 2013

(in thousands, except per share data)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Income (loss) before income taxes	$ 2,216	$ (569)
Income tax expense (benefit)	674	(830)
Net income	$ 1,542	$ 261
Effective dividend and accretion on preferred stock	261	230
Net income available to common shareholders	$ 1,281	$ 31
Earnings per common share, basic and diluted	$ 0.26	$ 0.01

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

Six months ended June 30, 2014 and 2013

(in thousands, except per share data)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Interest and Dividend Income		
Interest and fees on loans	$ 8,618	$ 9,749
Interest on deposits in banks	30	27
Interest and dividends on securities available for sale:		
Taxable interest	1,124	815
Tax-exempt interest	190	149
Dividends	42	38
Total interest and dividend income	$ 10,004	$ 10,778
Interest Expense		
Interest on deposits	$ 772	$ 1,338
Interest on trust preferred capital notes	108	111
Interest on other borrowings	59	59
Total interest expense	$ 939	$ 1,508
Net interest income	$ 9,065	$ 9,270
Provision for (recovery of) loan losses	(600)	2,250
Net interest income after provision for (recovery of) loan losses	$ 9,665	$ 7,020
Noninterest Income		
Service charges on deposit accounts	$ 1,273	$ 923
ATM and check card fees	700	698
Wealth management fees	956	827
Fees for other customer services	213	216
Net gains on sale of loans		124
Net gains on sale of securities available for sale	22	

Other operating income		177		747
Total noninterest income	$	3,341	$	3,535
Noninterest Expense				
Salaries and employee benefits	$	5,063	$	5,077
Occupancy		593		674
Equipment		599		587
Marketing		235		223
Stationery and supplies		174		156
Legal and professional fees		449		398
ATM and check card fees		326		326
FDIC assessment		294		521
Bank franchise tax		199		138
Other real estate owned, net		(39)		483
Telecommunications		144		140
Data processing		249		178
Loss on disposal of premises and equipment		2		3
Loss on land lease termination				206
Other operating expense		873		760
Total noninterest expense	$	9,161	$	9,870

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

(Continued)

Six months ended June 30, 2014 and 2013

(in thousands, except per share data)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Income before income taxes	$ 3,845	$ 685
Income tax expense (benefit)	1,157	(559)
Net income	$ 2,688	$ 1,244
Effective dividend and accretion on preferred stock	481	455
Net income available to common shareholders	$ 2,207	$ 789
Earnings per common share, basic and diluted	$ 0.45	$ 0.16

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income (Loss)

Three months ended June 30, 2014 and 2013

(in thousands)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Net income	$ 1,542	$ 261
Other comprehensive income (loss), net of tax,		
Unrealized holding gains (losses) on available for sale securities, net of tax $239 and $0, respectively	465	(2,561)
Reclassification adjustment for gains included in net income, net of tax ($7) and $0, respectively	(15)	
Total other comprehensive income (loss)	450	(2,561)
Total comprehensive income (loss)	$ 1,992	$ (2,300)

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income (Loss)

Six months ended June 30, 2014 and 2013

(in thousands)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Net income	$ 2,688	$ 1,244
Other comprehensive income (loss), net of tax,		
Unrealized holding gains (losses) on available for sale securities, net of tax $471 and $0, respectively	915	(2,693)
Reclassification adjustment for gains included in net income, net of tax ($7) and $0, respectively	(15)	
Total other comprehensive income (loss)	900	(2,693)
Total comprehensive income (loss)	$ 3,588	$ (1,449)

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Six months ended June 30, 2014 and 2013

(in thousands)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Cash Flows from Operating Activities		
Net income	$ 2,688	$ 1,244
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	494	492
Origination of loans held for sale		(2,567)
Proceeds from sale of loans held for sale		3,194
Net gains on sales of loans held for sale		(124)
Provision for (recovery of) loan losses	(600)	2,250
Provision for other real estate owned	86	448
Net gains on sale of securities available for sale	(22)	
Net gains on sale of other real estate owned	(160)	(64)
Losses on disposal of premises and equipment	2	3
Income from bank owned life insurance	(163)	(130)
Accretion of discounts and amortization of premiums on securities, net	322	504
Changes in assets and liabilities:		
Decrease in interest receivable	44	34
(Increase) decrease in other assets	342	(766)
Increase (decrease) in other liabilities	(1,137)	841
Net cash provided by operating activities	$ 1,896	$ 5,359
Cash Flows from Investing Activities		
Proceeds from sales of securities available for sale	$ 3,453	$ 1,850
Proceeds from maturities, calls, and principal payments of securities available for sale	6,247	13,461
Purchase of securities available for sale	(14,219)	(34,216)
Proceeds from redemption of restricted securities	168	169
Purchase of premises and equipment	(160)	(122)
Proceeds from sale of other real estate owned	1,021	1,927
Net (increase) decrease in loans	(10,574)	3,043

Net cash used in investing activities	$ (14,064)	$ (13,888)
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$ 8,370	$ 17,990
Net decrease in time deposits	(7,883)	(8,949)
Principal payments on other borrowings	(13)	(12)
Cash dividends paid on preferred stock	(379)	(379)
Cash dividends paid on common stock, net of reinvestment	(113)	
Net cash provided by (used in) financing activities	$ (18)	$ 8,650
Increase (decrease) in cash and cash equivalents	$ (12,186)	$ 121
Cash and Cash Equivalents		
Beginning	$ 31,508	$ 31,028
Ending	$ 19,322	$ 31,149

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Six months ended June 30, 2014 and 2013

(in thousands, except per share data)

	(unaudited) June 30, 2014	(unaudited) June 30, 2013
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 965	$ 1,540
Income Taxes	$ 321	$ 310
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gains (losses) on securities available for sale	$ 1,364	$ (2,693)
Transfer from loans to other real estate owned	$ 139	$ 191
Transfer from premises and equipment to other real estate owned	$	$ 224
Transfer from other assets to other real estate owned	$	$ 452
Issuance of common stock, dividend reinvestment plan	$ 9	$

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

Six months ended June 30, 2014 and 2013

(in thousands)

(unaudited)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2012	$ 14,409	$ 6,127	$ 6,813	$ 18,399	$ (859)	$ 44,889
Net income				1,244		1,244
Other comprehensive loss					(2,693)	(2,693)
Cash dividends on preferred stock				(379)		(379)
Accretion of preferred stock discount	76			(76)		
Balance, June 30, 2013	$ 14,485	$ 6,127	$ 6,813	$ 19,188	$ (3,552)	$ 43,061

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2013	$ 14,564	$ 6,127	$ 6,813	$ 27,360	$ (1,304)	$ 53,560
Net income				2,688		2,688
Other comprehensive income					900	900
Cash dividends on common stock ($0.025 per share)				(122)		(122)
Issuance of 1,118 shares common stock, dividend reinvestment plan		1	8			9
Cash dividends on preferred stock				(379)		(379)
Accretion of preferred stock discount	31			(31)		

Balance, June 30, 2014	$ 14,595	$ 6,128	$ 6,821	$ 29,516	$ (404)	$ 56,656

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Notes to Consolidated Financial Statements

(unaudited)

Note 1. General

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2014 and December 31, 2013, the results of operations and comprehensive income (loss) for the three and six months ended June 30, 2014 and 2013 and the cash flows and changes in shareholders equity for the six months ended June 30, 2014 and 2013. 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, 2013. Operating results for the three and six month periods ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

Recent Accounting Pronouncements

In January 2014, the FASB issued ASU 2014-01, Investments Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-01 to have an impact on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the

residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company does not expect the adoption of ASU 2014-04 to have an impact on its consolidated financial statements.

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Notes to Consolidated Financial Statements

(unaudited)

In April 2014, the FASB issued ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization s operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: Topic 606 . This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, Revenue Recognition , most industry-specific guidance, and some cost guidance included in Subtopic 605-35, Revenue Recognition Construction-Type and Production-Type Contracts . The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures . This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new

disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The Company does not expect the adoption of ASU 2014-11 to have an impact on its consolidated financial statements.

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Notes to Consolidated Financial Statements

(unaudited)

In June 2014, the FASB issued ASU No. 2014-12, Compensation Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period . The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in Compensation Stock Compensation (Topic 718) , should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at June 30, 2014 and December 31, 2013 were as follows (in thousands):

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 87,515	$ 961	$ (1,410)	$ 87,066
Obligations of states and political subdivisions	21,716	374	(278)	21,812
Corporate equity securities	1	5		6
	$ 109,232	$ 1,340	$ (1,688)	$ 108,884

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 86,365	$ 670	$ (2,138)	$ 84,897

Obligations of states and political subdivisions	18,647	350	(598)	18,399
Corporate equity securities	1	4		5
	$ 105,013	$ 1,024	$ (2,736)	$ 103,301

At June 30, 2014 and December 31, 2013, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	June 30, 2014					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	$ 16,702	$ (255)	$ 36,372	$ (1,155)	$ 53,074	$ (1,410)
Obligations of states and political subdivisions	2,795	(21)	6,999	(257)	9,794	(278)
	$ 19,497	$ (276)	$ 43,371	$ (1,412)	$ 62,868	$ (1,688)

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Notes to Consolidated Financial Statements

(unaudited)

	December 31, 2013					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	$ 49,810	$ (1,755)	$ 10,180	$ (383)	$ 59,990	$ (2,138)
Obligations of states and political subdivisions	7,165	(422)	2,663	(176)	9,828	(598)
	$ 56,975	$ (2,177)	$ 12,843	$ (559)	$ 69,818	$ (2,736)

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, 2014, there were thirty-three U.S. agency and mortgage-backed securities and eighteen obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company s investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.2 years at June 30, 2014. At December 31, 2013, there were forty U.S. agency and mortgage-backed securities and twenty-one 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, 2013. The weighted-average re-pricing term of the portfolio was 4.5 years at December 31, 2013. The unrealized losses at June 30, 2014 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.

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, 2014, and no impairment has been recognized. Restricted securities are not part of the available for sale securities portfolio.

The composition of restricted securities at June 30, 2014 and December 31, 2013 was as follows (in thousands):

	June 30, 2014	December 31, 2013
Federal Home Loan Bank stock	$ 740	$ 908
Federal Reserve Bank stock	846	846
Community Bankers Bank stock	50	50
	$ 1,636	$ 1,804

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Notes to Consolidated Financial Statements

(unaudited)

Note 3. Loans

Loans at June 30, 2014 and December 31, 2013 are summarized as follows (in thousands):

	June 30, 2014	December 31, 2013
Real estate loans:		
Construction and land development	$ 32,795	$ 34,060
Secured by 1-4 family residential	151,043	141,961
Other real estate loans	146,483	145,968
Commercial and industrial loans	24,797	22,803
Consumer and other loans	12,372	12,301
Total loans	$ 367,490	$ 357,093
Allowance for loan losses	(10,006)	(10,644)
Loans, net	$ 357,484	$ 346,449

Net deferred loan fees included in the above loan categories were $79 thousand and $18 thousand at June 30, 2014 and December 31, 2013, respectively. Consumer and other loans included $229 thousand and $279 thousand of demand deposit overdrafts at June 30, 2014 and December 31, 2013, 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 credit-worthiness of the borrower and changes in the value of the collateral.

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

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

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

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The following table provides a summary of loan classes and an aging of past due loans as of June 30, 2014 and December 31, 2013 (in thousands):

	June 30, 2014							
	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
Real estate loans:								
Construction and land development	$ 2,277	$ 72	$ 3,454	$ 5,803	$ 26,992	$ 32,795	$ 5,451	$ 167
1-4 family residential	1,417	650	378	2,445	148,598	151,043	1,025	158
Other real estate loans	590	277	1,327	2,194	144,289	146,483	4,592	
Commercial and industrial	329	19		348	24,449	24,797	153	
Consumer and other loans	10			10	12,362	12,372		
Total	$ 4,623	$ 1,018	$ 5,159	$ 10,800	$ 356,690	$ 367,490	$ 11,221	$ 325

	December 31, 2013							
	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

Real estate loans:								
Construction and land development	$ 161	$ 2,852	$ 3,339	$ 6,352	$ 27,708	$ 34,060	$ 5,811	$
1-4 family residential	1,561	316	136	2,013	139,948	141,961	953	27
Other real estate loans	1,077	1,636	74	2,787	143,181	145,968	4,756	
Commercial and industrial	165		22	187	22,616	22,803	144	22
Consumer and other loans	41	5		46	12,255	12,301	14	
Total	$ 3,005	$ 4,809	$ 3,571	$ 11,385	$ 345,708	$ 357,093	$ 11,678	$ 49

Credit Quality Indicators

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

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

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

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

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

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

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2014 and December 31, 2013 (in thousands):

	June 30, 2014				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 20,402	$ 2,939	$ 9,454	$	$ 32,795
Secured by 1-4 family residential	138,380	6,406	6,257		151,043
Other real estate loans	120,964	10,216	15,303		146,483
Commercial and industrial	24,066	246	485		24,797
Consumer and other loans	12,372				12,372
Total	$ 316,184	$ 19,807	$ 31,499	$	$ 367,490

	December 31, 2013				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 19,724	$ 3,500	$ 10,836	$	$ 34,060
Secured by 1-4 family residential	130,048	5,378	6,535		141,961
Other real estate loans	118,663	10,227	17,078		145,968

Commercial and industrial	21,563	555	685	22,803
Consumer and other loans	12,287		14	12,301
Total	$ 302,285	$ 19,660	$ 35,148	$ $ 357,093

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the six months ended June 30, 2014 and 2013 and for the year ended December 31, 2013 were as follows (in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Balance at beginning of year	$ 10,644	$ 13,075	$ 13,075
Provision charged to (recovery from) operating expense	(600)	(425)	2,250
Loan recoveries	507	2,486	498
Loan charge-offs	(545)	(4,492)	(3,345)
Balance at end of period	$ 10,006	$ 10,644	$ 12,478

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The following tables present, as of June 30, 2014, December 31, 2013 and June 30, 2013, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology (in thousands).

	June 30, 2014					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2013	$ 2,710	$ 2,975	$ 4,418	$ 442	$ 99	$ 10,644
Charge-offs		(104)	(203)	(36)	(202)	(545)
Recoveries	40	7	339	3	118	507
Provision for (recovery of) loan losses	(636)	18	(167)	65	120	(600)
Ending Balance, June 30, 2014	$ 2,114	$ 2,896	$ 4,387	$ 474	$ 135	$ 10,006
Ending Balance:						
Individually evaluated for impairment	779	126	911	57		1,873
Collectively evaluated for impairment	1,335	2,770	3,476	417	135	8,133
Loans:						
Ending Balance	32,795	151,043	146,483	24,797	12,372	367,490
Individually evaluated for impairment	6,427	3,297	9,994	164		19,882
Collectively evaluated for impairment	26,368	147,746	136,489	24,633	12,372	347,608

	December 31, 2013
	Total

	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	
Allowance for loan losses:						
Beginning Balance, December 31, 2012	$ 2,481	$ 3,712	$ 6,163	$ 608	$ 111	$ 13,075
Charge-offs	(2,962)	(260)	(1,070)	(37)	(163)	(4,492)
Recoveries		823	1,304	179	180	2,486
Provision for (recovery of) loan losses	3,191	(1,300)	(1,979)	(308)	(29)	(425)
Ending Balance, December 31, 2013	$ 2,710	$ 2,975	$ 4,418	$ 442	$ 99	$ 10,644
Ending Balance:						
Individually evaluated for impairment	882	190	263	44		1,379
Collectively evaluated for impairment	1,828	2,785	4,155	398	99	9,265
Loans:						
Ending Balance	34,060	141,961	145,968	22,803	12,301	357,093
Individually evaluated for impairment	6,862	3,431	11,143	258		21,694
Collectively evaluated for impairment	27,198	138,530	134,825	22,545	12,301	335,399

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	June 30, 2013					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2012	$ 2,481	$ 3,712	$ 6,163	$ 608	$ 111	$ 13,075
Charge-offs	(2,308)	(172)	(798)		(67)	(3,345)
Recoveries		6	206	176	110	498
Provision for (recovery of) loan losses	3,097	179	(561)	(399)	(66)	2,250
Ending Balance, June 30, 2013	$ 3,270	$ 3,725	$ 5,010	$ 385	$ 88	$ 12,478
Ending Balance:						
Individually evaluated for impairment	747	195	161	19		1,122
Collectively evaluated for impairment	2,523	3,530	4,849	366	88	11,356
Loans:						
Ending Balance	44,305	145,628	159,834	19,701	8,045	377,513
Individually evaluated for impairment	3,595	1,940	5,219	90		10,844
Collectively evaluated for impairment	40,710	143,688	154,615	19,611	8,045	366,669

Impaired loans and the related allowance at June 30, 2014, December 31, 2013 and June 30, 2013, were as follows (in thousands):

	June 30, 2014					
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized

Real estate loans:							
Construction and land development	$ 8,746	$ 4,022	$ 2,405	$ 6,427	$ 779	$ 6,607	$ 21
Secured by 1-4 family	4,230	2,766	531	3,297	126	3,248	62
Other real estate loans	10,501	7,347	2,647	9,994	911	10,998	125
Commercial and industrial	170	11	153	164	57	185	1
Consumer and other loans							
Total	$ 23,647	$ 14,146	$ 5,736	$ 19,882	$ 1,873	$ 21,038	$ 209

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	December 31, 2013						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction and land development	$ 9,086	$ 4,259	$ 2,603	$ 6,862	$ 882	$ 5,397	$ 204
Secured by 1-4 family	4,341	2,515	916	3,431	190	2,864	146
Other real estate loans	12,385	9,455	1,688	11,143	263	7,079	441
Commercial and industrial	260	114	144	258	44	669	14
Consumer and other loans							
Total	$ 26,072	$ 16,343	$ 5,351	$ 21,694	$ 1,379	$ 16,009	$ 805

	June 30, 2013						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction and land development	$ 6,245	$ 2,678	$ 917	$ 3,595	$ 747	$ 5,059	$ 20
Secured by 1-4 family	2,864	856	1,084	1,940	195	3,047	14
Other real estate loans	6,242	3,877	1,342	5,219	161	8,682	90
Commercial and industrial	91		90	90	19	87	2
Consumer and other loans							
Total	$ 15,442	$ 7,411	$ 3,433	$ 10,844	$ 1,122	$ 16,875	$ 126

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.

As of June 30, 2014, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled $2.0 million. At June 30, 2014, $978 thousand of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were $1.9 million in

TDRs at December 31, 2013, $829 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 was one new other real estate loan modified under a TDR during the six month period ended June 30, 2014. The recorded investment for this loan prior to the modification totaled $283 thousand and the recorded investment after the modification totaled $344 thousand. There were no loans modified under TDRs during the three month period ended June 30, 2014 and the three and six month periods ended June 30, 2013.

For the three and six months ended June 30, 2014 and 2013, 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 charged-off during the twelve month period subsequent to the modification.

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Note 5. Other Real Estate Owned (OREO)

At June 30, 2014 and December 31, 2013, OREO totaled $2.2 million and $3.0 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows (in thousands):

	For the six months ended June 30, 2014	For the year ended December 31, 2013
Balance at the beginning of year, gross	$ 4,695	$ 7,764
Transfers in	139	2,036
Charge-offs	(163)	(1,564)
Sales proceeds	(1,021)	(3,618)
Gain on disposition	160	80
Depreciation	(1)	(3)
Balance at the end of period, gross	$ 3,809	$ 4,695
Less: valuation allowance	(1,588)	(1,665)
Balance at the end of period, net	$ 2,221	$ 3,030

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

	For the six months ended June 30, 2014	June 30, 2013	For the year ended December 31, 2013
Balance at beginning of year	$ 1,665	$ 2,174	$ 2,174
Provision for losses	86	448	1,055
Transfer in		62	
Charge-offs, net	(163)	(601)	(1,564)
Balance at end of period	$ 1,588	$ 2,083	$ 1,665

Net expenses applicable to OREO, other than the provision for losses, were $35 thousand and $99 thousand for the six months ended June 30, 2014 and 2013, respectively and $150 thousand for the year ended December 31, 2013.

Note 6. Other Borrowings

The Bank had unused lines of credit totaling $103.4 million and $108.4 million available with non-affiliated banks at June 30, 2014 and December 31, 2013, respectively. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled $63.7 million at June 30, 2014.

At June 30, 2014 and December 31, 2013, the Bank had borrowings from the FHLB system totaling $6.0 million which mature through December 28, 2018. The interest rate on these notes payable ranged from 1.78% to 2.04% and the weighted average rate was 1.91%. The Bank also had a letter of credit from the FHLB totaling $30.0 million and $25.0 million at June 30, 2014 and December 31, 2013, respectively. The Bank had collateral pledged on the borrowings and the letter of credit at June 30, 2014 and December 31, 2013 including real estate loans totaling $66.9 million and $78.6 million, respectively, and Federal Home Loan Bank stock with a book value of $740 thousand and $908 thousand, respectively.

At June 30, 2014 and December 31, 2013, the Bank had a note payable totaling $39 and $52 thousand, respectively, secured by a deed of trust, which requires monthly payments of $2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%.

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Note 7. Capital Requirements

A comparison of the capital of the Company and the Bank at June 30, 2014 and December 31, 2013 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
June 30, 2014:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 69,455	18.64%	$ 29,803	8.00%	N/A	N/A
First Bank	$ 64,302	17.28%	$ 29,762	8.00%	$ 37,202	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 64,732	17.38%	$ 14,902	4.00%	N/A	N/A
First Bank	$ 59,586	16.02%	$ 14,881	4.00%	$ 22,321	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 64,732	12.22%	$ 21,186	4.00%	N/A	N/A
First Bank	$ 59,586	11.26%	$ 21,171	4.00%	$ 26,463	5.00%
December 31, 2013:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 66,437	18.21%	$ 29,193	8.00%	N/A	N/A
First Bank	$ 60,578	16.62%	$ 29,160	8.00%	$ 36,450	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 61,800	16.94%	$ 14,597	4.00%	N/A	N/A
First Bank	$ 55,947	15.35%	$ 14,580	4.00%	$ 21,870	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 61,800	11.75%	$ 21,047	4.00%	N/A	N/A
First Bank	$ 55,947	10.68%	$ 20,948	4.00%	$ 26,184	5.00%

Note 8. Trust Preferred Capital Notes

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On

June 17, 2004, $5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at June 30, 2014 and December 31, 2013 was 2.83% and 2.84%, 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 securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the trust preferred securities.

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, 2014 and December 31, 2013 was 1.83% and 1.85%, 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 securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the trust preferred securities.

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While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2014 and December 31, 2013, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital.

Note 9. 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 are 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.

Components of the net periodic benefit cost of the plan for the three and six months ended June 30, 2014 and 2013 were as follows (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Service cost	$ 87	$ 118	$ 174	$ 236
Interest cost	67	70	134	140
Expected return on plan assets	(79)	(76)	(158)	(152)
Amortization of net loss		27		54
Net periodic benefit cost	$ 75	$ 139	$ 150	$ 278

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2013, that it expected to make no contribution to its pension plan during the year ended December 31, 2014. 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 11 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013 for additional information about the Company s benefit plans.

Note 10. 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. There are no potential common shares that would have a dilutive effect. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 4,901,599 and 4,901,464 for the three months ended June 30, 2014 and 2013, respectively, and 4,901,532 and 4,901,464 for the six months ended June 30, 2014 and 2013 respectively.

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Note 11. 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 an 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 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, 2014 and December 31, 2013 (in thousands).

		Fair Value Measurements at June 30, 2014		
Description	Balance as of June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				
U.S. agency and mortgage-backed securities	$ 87,066	$	$ 87,066	$
Obligations of states and political subdivisions	21,812		21,812	
Corporate equity securities	6	6		
	$ 108,884	$ 6	$ 108,878	$

		Fair Value Measurements at December 31, 2013		
Description	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				

U.S. agency and mortgage-backed securities	$ 84,897	$	$ 84,897	$
Obligations of states and political subdivisions	18,399		18,399	
Corporate equity securities	5	5		
	$ 103,301	$ 5	$ 103,296	$

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.

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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:

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 either 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 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.

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	Balance as of June 30, 2014	Fair Value Measurements at June 30, 2014		
		Quoted Prices in Active Markets for	Significant Other Observable Inputs	Significant Unobservable Inputs (Level 3)

		Identical Assets (Level 1)	(Level 2)	
Assets				
Impaired loans, net	$ 3,863	$	$	$ 3,863
Other real estate owned, net	2,221			2,221

	Fair Value Measurements at December 31, 2013			
Description	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans, net	$ 3,972	$	$	$ 3,972
Other real estate owned, net	3,030			3,030

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	Quantitative information about Level 3 Fair Value Measurements for June 30, 2014			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Assets				
Impaired loans, net	$ 3,863	Property appraisals	Selling cost	10%
			Discount for lack of marketability and age of appraisal	0-19% (5%)
Other real estate owned, net	$ 2,221	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.

Restricted Securities

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

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.

Deposit Liabilities

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Borrowings

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

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Bank Owned Life Insurance

The carrying amounts of bank owned life insurance approximate 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, 2014 and December 31, 2013, fair value of loan commitments and standby letters of credit was immaterial.

The carrying values and estimated fair values of the Company s financial instruments at June 30, 2014 and December 31, 2013 are as follows (in thousands):

		Fair Value Measurements at June 30, 2014 Using			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
Financial Assets					
Cash and short-term investments	$ 19,322	$ 19,322	$	$	$ 19,322
Securities	108,884	6	108,878		108,884
Restricted securities	1,636		1,636		1,636
Loans, net	357,484			365,034	365,034
Bank owned life insurance	11,141		11,141		11,141
Accrued interest receivable	1,258		1,258		1,258
Financial Liabilities					
Deposits	$ 451,198	$	$ 335,325	$ 116,179	$ 451,504

Other borrowings	6,039		6,137	6,137
Trust preferred capital notes	9,279		10,351	10,351
Accrued interest payable	151	151		151

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	Fair Value Measurements at December 31, 2013 Using				
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
Financial Assets					
Cash and short-term investments	$ 31,508	$ 31,508	$	$	$ 31,508
Securities	103,301	5	103,296		103,301
Restricted securities	1,804		1,804		1,804
Loans, net	346,449			353,874	353,874
Bank owned life insurance	10,978		10,978		10,978
Accrued interest receivable	1,302		1,302		1,302
Financial Liabilities					
Deposits	$ 450,711	$	$ 326,955	$ 124,422	$ 451,377
Other borrowings	6,052			6,095	6,095
Trust preferred capital notes	9,279			9,399	9,399
Accrued interest payable	177		177		177

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 12. Preferred Stock

The Company has (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 pays cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock was amortized over a five year period using the constant effective yield method.

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Note 13. 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
Balance at December 31, 2012	$ 1,770	$ (2,629)	$ (859)
Unrealized holding losses (net of tax, $0)	(2,693)		(2,693)
Change during period	(2,693)		(2,693)
Balance at June 30, 2013	$ (923)	$ (2,629)	$ (3,552)
Balance at December 31, 2013	$ (1,129)	$ (175)	$ (1,304)
Unrealized holding gains (net of tax, $471)	915		915
Reclassification adjustment (net of tax, $7)	(15)		(15)
Change during period	900		900
Balance at June 30, 2014	$ (229)	$ (175)	$ (404)

The following tables present information related to reclassifications from accumulated other comprehensive loss for the three and six month periods ended June 30, 2014 and 2013 (in thousands):

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statements of Income

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss		Affected Line Item in the Consolidated Statements of Income
	For the three months ended June 30,		
	2014	**2013**	
Securities available for sale:			
Net securities gains reclassified into earnings	$ (22)	$	Net gains on sale of securities available for sale
Related income tax expense	7		Income tax expense
Total reclassifications	$ (15)	$	Net of tax

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss		Affected Line Item in the Consolidated Statements of Income
	For the six months ended June 30,		
	2014	**2013**	
Securities available for sale:			
Net securities gains reclassified into earnings	$ (22)	$	Net gains on sale of securities available for sale
Related income tax expense	7		Income tax expense
Total reclassifications	$ (15)	$	Net of tax

Note 14. Subsequent Event

On August 13, 2014, the Board of Directors of the Company declared a quarterly dividend of $0.025 per common share, which is payable on September 19, 2014 to shareholders of record as of September 5, 2014.

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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 wo 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:

adverse economic conditions in the market area and the impact on credit quality and risks inherent in the loan portfolio such as repayment risk and fluctuating collateral values;

additional future losses if our levels of non-performing assets do not moderate and if the proceeds we receive upon liquidation of assets are less than the carrying value of such assets;

further increases of non-performing assets may reduce interest income and increase net charge-offs, provision for loan losses, and operating expenses;

the adequacy of the allowance for loan losses related to specific reserves on impaired loans, and changes in factors considered such as general economic and business conditions in the market area and overall asset quality;

the adequacy of the valuation allowance for other real estate owned related to changes in economic conditions and local real estate activity;

loss or retirement of key executives;

the ability to compete effectively in the highly competitive banking industry;

legislative or regulatory changes, including changes in accounting standards, may adversely affect the businesses that the Company is engaged in;

the ability to implement various technologies into operations may impact the Company s ability to operate profitably;

the ability of the Company to implement its disaster recovery plan in the event of a natural or other disaster;

losses that could arise from breaches in cyber-security;

the ability to raise capital as needed;

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;

the reliance on secondary sources, such as Federal Home Loan Bank advances, sales of securities and loans, federal funds lines of credit from correspondent banks and out-of-market time deposits, to meet liquidity needs;

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, 2013.

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, 2014 and results of operations of the Company for the three and six month periods ended June 30, 2014 and 2013 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, 2013. The results of operations for the three and six month periods ended June 30, 2014 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.

Products, Services, Customers and Locations

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

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

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

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

The Bank s products and services are provided through 10 branch offices, 1 customer service center, 25 ATMs and its website, www.fbvirginia.com. The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank s financial services at one location. This concept allows loan, deposit, and wealth management personnel to be readily available to serve customers throughout the Bank s market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2013.

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% to 75% 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.

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The provision for loan losses and noninterest expense are generally the two major expense categories. The provision is determined by factors that include net charge-offs, asset quality, economic conditions and loan growth. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company s control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for or recovery of loan losses. The largest component of noninterest expense for the six month period ended June 30, 2014 was salaries and employee benefits, comprising 55% of noninterest expenses, followed by occupancy and equipment expense, comprising 13% of noninterest expenses.

Quarterly Performance

For the three months ended June 30, 2014, net income totaled $1.5 million compared to $261 thousand for the same period in 2013. After the effective dividend on preferred stock, net income available to common shareholders was $1.3 million, or $0.26 per basic and diluted share, compared to $31 thousand, or $0.01 per basic and diluted share, for the same period in 2013. Return on average assets and return on average equity were 1.16% and 11.05%, respectively, for the second quarter of 2014 compared to 0.19% and 2.32% for the same quarter in 2013.

Net interest income decreased by $15 thousand to $4.6 million, compared to the second quarter in 2013. The net interest margin was 3.81% for the second quarter of 2014 compared to 3.71% for the same period in 2013. The Bank recorded a recovery of loan losses of $400 thousand during the second quarter, compared to a provision for loan losses of $2.5 million for the same quarter in 2013. Noninterest income decreased $312 thousand, or 15%, to $1.7 million compared to $2.0 million for the same period one year ago primarily because the Company recorded a $543 thousand one-time gain on termination of a post-retirement obligation for directors during the second quarter of 2013. Noninterest income, excluding the one-time gain on termination of a post-retirement obligation for directors, increased 15%, or $231 thousand, compared to the same period one year ago. Noninterest expense decreased $212 thousand, or 4%, to $4.5 million for the quarter compared to $4.8 million for the same period in 2013.

Year-to-Date Performance

Net income totaled $2.7 million for the six months ended June 30, 2014 and $1.2 million for the same period in 2013. After the effective dividend on preferred stock, net income available to common shareholders was $2.2 million, or $0.45 per basic and diluted share, compared to $789 thousand, or $0.16 per basic and diluted share, for the same period in 2013. Return on average assets and return on average equity were 1.03% and 9.81%, respectively, for the six months ended June 30, 2014 compared to 0.47% and 5.57% for the same period in 2013.

For the six months ended June 30, 2014, net interest income decreased 2%, or $205 thousand, compared to the same period of 2013. The net interest margin was 3.77% for the six months ended June 30, 2014 compared to 3.75% for the same period in 2013. The Bank recorded a recovery of loan losses of $600 thousand, compared to a provision for loan losses of $2.3 million for the same period one year ago. Noninterest income decreased $194 thousand, or 5%, to $3.3 million compared to $3.5 million when comparing the two periods. Noninterest income, excluding the $543 thousand one-time gain on termination of a post-retirement obligation for directors in 2013, increased 12%, or $349 thousand, compared to the same period one year ago. Noninterest expense decreased $709 thousand, or 7%, to $9.2 million compared to $9.9 million for the same period in 2013.

Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO expense and loss on disposal of premises and equipment, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities gains and losses and the gain on termination of postretirement benefit

obligation. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the following table (dollars in thousands).

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Efficiency Ratio

	For the three months ended		For the six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Noninterest expense	$ 4,548	$ 4,760	$ 9,161	$ 9,870
Less: other real estate owned expense, net	70	(376)	39	(483)
Less: losses on premises and equipment		(3)	(2)	(3)
Less: loss on land lease termination				(206)
	$ 4,618	$ 4,381	$ 9,198	$ 9,178
Tax-equivalent net interest income	$ 4,716	$ 4,717	$ 9,219	$ 9,384
Noninterest income	1,725	2,037	3,341	3,535
Less: securities gains	(22)		(22)	
Less: gain on termination of postretirement benefit obligation		(543)		(543)
	$ 6,419	$ 6,211	$ 12,538	$ 12,376
Efficiency ratio	71.94%	70.54%	73.36%	74.14%

This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for each of 2014 and 2013 is 34%. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below (in thousands).

Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income

	For the three months ended		For the six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
GAAP measures:				
Interest income - loans	$ 4,403	$ 4,816	$ 8,618	$ 9,749
Interest income - investments and other	692	555	1,386	1,029
Interest expense - deposits	372	632	772	1,338
Interest expense - other borrowings	30	30	59	59
Interest expense - trust preferred capital notes	54	55	108	111
Total net interest income	$ 4,639	$ 4,654	$ 9,065	$ 9,270

Non-GAAP measures:				
Tax benefit realized on non-taxable interest income - loans	$ 28	$ 24	$ 56	$ 38
Tax benefit realized on non-taxable interest income - municipal securities	49	39	98	76
Total tax benefit realized on non-taxable interest income	$ 77	$ 63	$ 154	$ 114
Total tax-equivalent net interest income	$ 4,716	$ 4,717	$ 9,219	$ 9,384

Critical Accounting Policies

General

The Company s consolidated financial statements and related notes are prepared in accordance with GAAP. The financial information contained within the statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. The Bank uses historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from the historical factors used. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact transactions could change.

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

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management determines that the loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance. For further information about the Company s loans and the allowance for loan losses, see Notes 3 and 4 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.

The Bank 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 Bank 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 credit-worthiness of the borrower and changes in the value of the collateral.

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

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

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

The allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as impaired, and is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. For collateral dependent loans, an updated appraisal is ordered if a current one is not on file. Appraisals are performed by independent third-party appraisers with relevant industry experience. Adjustments to the appraised value may be made based on recent sales of like properties or general market conditions among other considerations.

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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 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.

Other Real Estate Owned (OREO)

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

Deferred Tax Asset Valuation Allowance

A valuation allowance is required for deferred tax assets (DTA) if, based on available evidence, it is more likely than not that all or some portion of the asset may not be realized due to the inability to generate sufficient taxable income in the period and/or of the character necessary to utilize the benefit of the deferred tax asset. In making this assessment, all sources of taxable income available to realize the deferred tax asset are considered, including taxable income in prior carry-back years, future reversals of existing temporary differences, tax planning strategies, and future taxable income exclusive of reversing temporary differences and carry-forwards. The predictability that future taxable income, exclusive of reversing temporary differences, will occur is the most subjective of these four sources. The presence of cumulative losses in recent years is considered significant negative evidence, making it difficult for a company to rely on future taxable income, exclusive of reversing temporary differences and carry-forwards, as a reliable source of taxable income to realize a deferred tax asset. Judgment is a critical element in making this assessment. Changes in the valuation allowance that result from favorable changes in those circumstances that cause a change in judgment about the realization of deferred tax assets in future years are recorded through income tax expense.

In assessing the need for a valuation allowance, the Company considered all available evidence about the realization of DTAs, both positive and negative, that could be objectively verified. The Company s positive evidence considered was sufficient to overcome the negative evidence and as a result, a valuation allowance on deferred income tax assets was not warranted as of June 30, 2014.

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

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directors. The Board Loan Committee approves the Bank s Loan Policy and reviews the loan watch list, concentrations of credit and other risk management reports. The Board Loan Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

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

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, 2014, commitments to extend credit and stand-by letters of credit totaled $69.2 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

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estate loan underwriting criteria require an examination of debt service coverage ratios, the borrower s creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers principal owners and considers the valuation of the real estate collateral.

Commercial and Industrial Lending

Commercial and industrial loans generally have a higher degree of risk than loans secured by real estate, but typically have higher yields. Commercial business loans typically are made on the basis of the borrower s ability to make repayment from cash flow from its business and are secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much reliability as residential real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower s principal owners and monitors the financial condition of its business borrowers.

Consumer Lending

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

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

Results of Operations

General

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

Net Interest Income

Net interest income totaled $4.6 million for the second quarter of 2014, which was a $15 thousand decrease when compared to the same period a year ago. The net interest margin increased to 3.81% from 3.71% and average earning assets were $13.6 million lower when comparing the periods. Interest-earning asset yields decreased 9 basis points while the cost of funds decreased 19 basis points.

For the six months ended June 30, 2014, net interest income totaled $9.1 million, which was a 2% decrease when compared to the same period a year ago. The net interest margin increased to 3.77% from 3.75% and average earning assets were $10.8 million lower when comparing the periods. Interest-earning asset yields decreased 21 basis points while the cost of funds decreased 22 basis points.

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For both the three month and six month periods ended June 30, 2014, interest-earning asset yields decreased from lower yields earned on loans, as well as higher balances of securities and lower balances of loans, when comparing to the same periods in 2013. Although funding costs also fell during those periods, the decreases in the cost of funds exceeded the decreases in the yields on interest-earning assets, which resulted in higher net interest margins for the 2014 periods compared to the 2013 periods.

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, 2014			June 30, 2013		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets						
Securities:						
Taxable	$ 97,872	$ 562	2.30%	$ 90,529	$ 443	1.96%
Tax-exempt [1]	12,182	144	4.74%	7,452	116	6.25%
Restricted	1,636	21	5.12%	1,804	19	4.15%
Total securities	$ 111,690	$ 727	2.61%	$ 99,785	$ 578	2.32%
Loans: [2]						
Taxable	$ 352,849	$ 4,348	4.94%	$ 376,211	$ 4,770	5.09%
Tax-exempt [1]	7,518	83	4.43%	6,035	69	4.59%
Total loans	$ 360,367	$ 4,431	4.93%	$ 382,246	$ 4,839	5.08%
Federal funds sold				3		
Interest-bearing deposits with other institutions	24,247	14	0.23%	27,905	17	0.24%
Total earning assets	$ 496,304	$ 5,172	4.18%	$ 509,939	$ 5,434	4.27%
Less: allowance for loan losses	(10,553)			(13,044)		
Total non-earning assets	45,499			43,186		
Total assets	$ 531,250			$ 540,081		
Liabilities and Shareholders Equity						
Interest bearing deposits:						
Checking	$ 118,607	$ 44	0.15%	$ 113,869	$ 76	0.27%
Regular savings	103,075	22	0.09%	99,253	35	0.14%
Money market accounts	18,793	5	0.11%	16,678	5	0.12%
Time deposits:						

$100,000 and over	48,302	153	1.27%	62,836	248	1.58%
Under $100,000	64,124	142	0.89%	79,588	253	1.27%
Brokered	4,981	7	0.54%	10,601	15	0.57%
Total interest-bearing deposits	$ 357,882	$ 373	0.42%	$ 382,825	$ 632	0.66%
Federal funds purchased	3			3		
Trust preferred capital notes	9,279	54	2.35%	9,279	55	2.40%
Other borrowings	6,043	30	1.99%	6,067	30	1.96%
Total interest-bearing liabilities	$ 373,207	$ 457	0.49%	$ 398,174	$ 717	0.72%
Non-interest bearing liabilities						
Demand deposits	99,633			92,016		
Other liabilities	2,445			4,795		
Total liabilities	$ 475,285			$ 494,985		
Shareholders equity	55,965			45,096		
Total liabilities and Shareholders equity	$ 531,250			$ 540,081		
Net interest income		$ 4,715			$ 4,717	
Interest rate spread			3.69%			3.55%
Interest expense as a percent of average earning assets			0.37%			0.56%
Net interest margin			3.81%			3.71%

(1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was $76 thousand and $63 thousand for the three months ended June 30, 2014 and 2013, respectively.

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

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

	For the six months ended					
	June 30, 2014			June 30, 2013		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets						
Securities:						
Taxable	$ 97,230	$ 1,124	2.33%	$ 86,932	$ 815	1.89%
Tax-exempt [1]	12,012	288	4.83%	7,338	226	6.22%
Restricted	1,712	42	4.96%	1,882	38	4.03%
Total securities	$ 110,954	$ 1,454	2.64%	$ 96,152	$ 1,079	2.26%
Loans: [2]						
Taxable	$ 349,602	$ 8,508	4.91%	$ 379,715	$ 9,675	5.14%
Tax-exempt [1]	7,495	167	4.48%	4,694	111	4.75%
Total loans	$ 357,097	$ 8,675	4.90%	$ 384,409	$ 9,786	5.13%
Federal funds sold				1		
Interest-bearing deposits with other institutions	25,378	30	0.24%	23,680	27	0.23%
Total earning assets	$ 493,429	$ 10,159	4.15%	$ 504,242	$ 10,892	4.36%
Less: allowance for loan losses	(10,566)			(13,247)		
Total non-earning assets	45,458			43,859		
Total assets	$ 528,321			$ 534,854		
Liabilities and Shareholders Equity						
Interest bearing deposits:						
Checking	$ 116,805	$ 90	0.16%	$ 109,869	$ 166	0.30%
Regular savings	101,901	44	0.09%	100,295	87	0.17%
Money market accounts	19,410	11	0.11%	15,457	10	0.13%
Time deposits:						
$100,000 and over	49,130	314	1.29%	64,054	511	1.61%
Under $100,000	65,764	298	0.91%	80,681	529	1.32%
Brokered	4,881	16	0.66%	10,072	35	0.70%
Total interest-bearing deposits	$ 357,891	$ 773	0.44%	$ 380,428	$ 1,338	0.71%
Federal funds purchased	1			1		
Trust preferred capital notes	9,279	108	2.35%	9,279	111	2.41%
Other borrowings	6,046	59	1.97%	6,070	59	1.96%

Total interest-bearing liabilities	$ 373,217	$ 940	0.51%	$ 395,778	$ 1,508	0.77%
Non-interest bearing liabilities						
Demand deposits	97,279			89,326		
Other liabilities	2,596			4,722		
Total liabilities	$ 473,092			$ 489,826		
Shareholders equity	55,229			45,028		
Total liabilities and Shareholders equity	$ 528,321			$ 534,854		
Net interest income		$ 9,219			$ 9,384	
Interest rate spread			3.64%			3.59%
Interest expense as a percent of average earning assets			0.38%			0.60%
Net interest margin			3.77%			3.75%

(1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was $154 thousand and $114 thousand for the six months ended June 30, 2014 and 2013, respectively.

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

Provision for Loan Losses

The Bank recorded recovery of loan losses of $400 thousand during the second quarter, which resulted in a total allowance for loan losses of $10.0 million or 2.72% of total loans at June 30, 2014. This compared to a provision for loan losses of $2.5 million and an allowance for loan losses of $12.5 million, or 3.31% of total loans, at the end of the same quarter in 2013. The recovery of loan losses during the second quarter of 2014 was primarily driven by net recoveries during the quarter and the impact of the improvement in the historical loss component of the calculation for allowance for loan losses. Net recoveries totaled $123 thousand for the second quarter of 2014 compared to $2.8 million of net charge-offs for the same period in 2013.

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For the six months ended June 30, 2014, recovery of loan losses totaled $600 thousand, compared to provision for loan losses of $2.3 million for the same period in 2013. The recovery of loan losses in 2014 was primarily the result of the improvement in the historical loss component of the calculation for allowance for loan losses offset by increases in specific reserves of $494 thousand from December 31, 2013, when compared to the same period in 2013. In 2013, the provision for loan losses resulted from net charge-offs and their impact on the historical loss component of the allowance for loan losses. Net charge-offs totaled $38 thousand for the six months ended June 30, 2014 compared to $2.8 million for the same period in 2013.

Noninterest Income

Noninterest income decreased $312 thousand, or 15%, to $1.7 million for the second quarter compared to $2.0 million for the same period one year ago. The decrease in noninterest income was primarily the result of a one-time gain of $543 thousand recorded on termination of a post-retirement obligation for directors during the same quarter in 2013. Noninterest income, excluding the one-time gain on termination of a post-retirement obligation for directors, increased 15%, or $231 thousand, compared to the same period one year ago. Revenue from service charges on deposit accounts increased by $179 thousand, or 39% and revenue from wealth management fees increased by $97 thousand, or 26%, comparing the second quarter to the same period one year ago. Revenue from service charges on deposit accounts increased primarily from increased core checking account activity and the increase in wealth management fees resulted primarily from higher balances of assets under management during the second quarter of 2014 compared to the same period one year ago.

For the six months ended June 30, 2014, noninterest income decreased $194 thousand, or 5%, to $3.3 million compared to $3.5 million for the same period one year ago. Noninterest income, excluding the one-time gain on termination of a post-retirement obligation for directors, increased 12%, or $349 thousand, compared to the same period one year ago. Revenue from service charges on deposit accounts increased by $350 thousand, or 38% and revenue from wealth management fees increased by $129 thousand, or 16%, when comparing the periods.

Noninterest Expense

Noninterest expense decreased $212 thousand, or 4%, to $4.5 million for the quarter compared to $4.8 million for the same quarter of 2013. The decrease in noninterest expense was primarily due to a $446 thousand decrease in expenses related to other real estate owned and a $58 thousand, or 32%, decrease in FDIC assessment expenses. These decreases were partially offset by increases in other operating expenses of $77 thousand, or 22%, and increases of $111 thousand, or 5%, in salaries and employee benefits. Increases in other operating expenses were primarily attributable to expenses related to a new feature provided to checking account customers that provides cash back rewards.

For the six months ended June 30, 2014, noninterest expense decreased $709 thousand, or 7%, to $9.2 million compared to $9.9 million for the same period in the prior year. Expenses related to other real estate owned decreased $522 thousand and FDIC assessment expenses decreased $227 thousand, or 44%, compared to the same period one year ago. Decreases in expenses related to other real estate owned resulted primarily from decreased write-downs in the carrying value of OREO property when comparing the periods. FDIC assessment expense decreased primarily as a result of an adjustment to the prepaid FDIC assessment balance during the first six months of 2013. Loss on land lease termination decreased $206 thousand when comparing the first six months of 2014 to the same period in 2013. During the first six months of 2014, the Company did not record a loss on land lease termination compared to a $206 thousand loss in 2013 that resulted from the Company s decision to terminate a land lease for branch expansion. These decreases were partially offset by increases in other operating expenses of $113 thousand, or 15%, increases of $71 thousand, or 40%, in data processing expenses, and increases of $61 thousand, or 44%, in bank franchise tax. Other

operating expenses increased primarily from a new feature provided to checking account customers. Increases in data processing were primarily attributable to the shift in customer behavior from traditional to electronic services. Bank franchise tax increased because of higher levels of capital when comparing the periods.

Income Taxes

The Company s income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income (loss) for the three and six month periods ended June 30, 2014 and 2013. 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 10 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

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Financial Condition

General

Total assets increased $2.4 million to $525.3 million at June 30, 2014 compared to $522.9 million at December 31, 2013. Assets under management of the wealth management division of the Bank increased by $27.9 million, or 10%, to $312.6 million at June 30, 2014 compared to $284.7 million at December 31, 2013. Assets managed by the wealth management division are not reflected on the Company s consolidated balance sheet.

Loans

Loans, net of the allowance for loan losses, totaled $357.5 million at June 30, 2014, an increase of $11.0 million, or 3%, from $346.5 million at December 31, 2013. Although the Company believes loan demand remained relatively low in its market area, loan origination amounts increased during the first six months of 2014, resulting in loan growth.

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.

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 northern 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. 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.

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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 $19.9 million and $21.7 million at June 30, 2014 and December 31, 2013, respectively.

Troubled Debt Restructurings (TDR)

In situations where, for economic or legal reasons related to a borrower s financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower s payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on 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 $2.0 million and $1.9 million in loans classified as TDRs as of June 30, 2014 and December 31, 2013, respectively.

Asset Quality

Management classifies as non-performing assets 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 had $2.2 million and $3.0 million in OREO, net of the valuation allowance, at June 30, 2014 and December 31, 2013, respectively. The valuation allowance for other real estate owned totaled $1.6 million and $1.7 million at June 30, 2014 and December 31, 2013, respectively.

Non-performing assets were $13.4 million at June 30, 2014 and $14.7 million at December 31, 2013, representing 2.55% and 2.81% of total assets, respectively. Non-performing assets included $11.2 million in non-accrual loans and $2.2 million in OREO, net of the valuation allowance at June 30, 2014. This compares to $11.7 million in non-accrual loans and $3.0 million in OREO, net of the valuation allowance at December 31, 2013.

The levels of non-performing assets at June 30, 2014 and December 31, 2013 were primarily attributable to weak local economic conditions that negatively impacted the ability of certain borrowers to service debt. Borrowers that have not been able to meet their debt requirements are primarily business customers involved in real estate development and commercial and residential real estate. At June 30, 2014, 52% of non-performing assets related to construction and land development loans, 35% related to commercial real estate loans, 9% related to residential real estate loans, 3% related to properties originally acquired for branch expansion no longer intended to be used for that purpose and 1% related to commercial and industrial loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower s ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in

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accordance with their terms. Other potential problem loans totaled $20.3 million and $23.5 million at June 30, 2014 and December 31, 2013, respectively. The amount of other potential problem loans in future periods may be dependent on economic conditions and other factors influencing our customers ability to meet their debt requirements.

The allowance for loan losses represents management s analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management s 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 $10.0 million at June 30, 2014 and $10.6 million at December 31, 2013, representing 2.72% and 2.98% of total loans, respectively. The decrease in the allowance was primarily a result of a decrease in the general allocation from an improvement in the historical loss experience in excess of the increase in specific reserves required on impaired loans. Recoveries of loan losses of $636 thousand and $167 thousand were experienced in the Construction and Land Development and Other Real Estate loan classes, respectively, during the six month period ended June 30, 2014. The recovery of loan losses in the Construction and Land Development loan class was primarily attributable to a decrease in the specific reserve and a decrease in the general allocation from an improvement in the historical loss experience. The recovery of loan losses in the Other Real Estate loan class resulted from a decrease in the general allocation from an improvement in the historical loss experience that exceeded the increase in the specific reserve.

Impaired loans totaled $19.9 million and $21.7 million at June 30, 2014 and December 31, 2013, respectively. The related allowance for loan losses provided for these loans totaled $1.9 million and $1.4 million at June 30, 2014 and December 31, 2013, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2014 and the year ended December 31, 2013 was $21.0 million and $16.0 million, respectively. Included in the impaired loans total at June 30, 2014 are loans classified as TDRs totaling $2.0 million. These loans represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of June 30, 2014, $978 thousand of these TDRs were performing under the restructured terms and were not considered non-performing assets.

Management believes, based upon its review and analysis, that the Bank has sufficient reserves to cover losses inherent within the loan portfolio. For each period presented, the provision for loan losses charged to expense was based on management s judgment after taking into consideration all factors connected with the collectability of the existing portfolio. Management considers economic conditions, historical loss factors, past due percentages, internally generated loan quality reports and other relevant factors when evaluating the loan portfolio. There can be no assurance, however, that an additional provision for loan losses will not be required in the future, including as a result of changes in the economic assumptions underlying management s estimates and judgments, adverse developments in the economy, on a national basis or in the Company s market area, or changes in the circumstances of particular borrowers. For further discussion regarding the allowance for loan losses, see Critical Accounting Policies .

Securities

Securities at June 30, 2014 totaled $108.9 million, an increase of $5.6 million or 5% from $103.3 million at December 31, 2013. 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, 2014, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios. Gross unrealized gains in the securities portfolio totaled $1.3 million and $1.0 million at June 30, 2014 and December 31, 2013, respectively. Gross unrealized losses totaled $1.7 million and $2.7 million at June 30, 2014 and December 31, 2013, respectively. Investments in an unrealized loss position were considered temporarily impaired at June 30, 2014 and December 31, 2013. The change in the unrealized gains and losses of investment securities from December 31, 2013 to June 30, 2014 was related to changes in market interest rates.

Deposits

Deposits totaled $451.2 million at June 30, 2014, a slight increase from $450.7 million at December 31, 2013. Non-interest bearing demand deposits increased $6.5 million or 7% to $99.4 million during the first six months of 2014 from $92.9 million at December 31, 2013. Savings and interest-bearing demand deposits increased $1.8 million or 1% to $235.9 million at June 30, 2014 compared to $234.1 million at December 31, 2013. Time deposits, which include brokered deposits, decreased $7.9 million or 6% during the first six months of 2014 to $115.9 million compared to $123.8 million at December 31, 2013.

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Liquidity

Liquidity represents the ability to meet present and future financial obligations through either the sale or maturity of existing assets or with borrowings from correspondent banks or other deposit markets. The Company classifies cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, investment securities and loans maturing within one year as liquid assets. As part of the Bank s liquidity risk management, stress tests and cash flow modeling are performed quarterly.

As a result of the Bank s management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors requirements and to meet its customers borrowing needs.

At June 30, 2014, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled $101.5 million. At June 30, 2014, 22% or $82.0 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled $103.4 million at June 30, 2014, which included $63.7 million available from FHLB, $37.0 million of unsecured federal funds lines of credit with other correspondent banks and $2.7 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 Board of Governors of the Federal Reserve System has adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.00%, of which at least 4.00% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. The Company had a ratio of total capital to risk-weighted assets of 18.64% at June 30, 2014 and a ratio of Tier 1 capital to risk-weighted assets of 17.38%. The Bank had a ratio of total capital to risk-weighted assets of 17.28% and a ratio of Tier 1 capital to risk-weighted assets of 16.02% at June 30, 2014. All of these exceed the capital requirements adopted by the federal regulatory agencies.

Under present regulations, trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2014 and December 31, 2013, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital. The Company is current on the interest payments on its trust preferred capital notes.

In July 2013, the Federal Reserve Board released its final rules which will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. The new rules are effective January 1, 2015. The Company and the Bank Under the final rule, minimum requirements will increase for both the quality and quantity of capital held by banking organizations. In this respect, the final rule implements strict eligibility criteria for regulatory capital instruments and improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Consistent with the international Basel framework, the rule includes a new minimum ratio of Common Equity Tier 1 Capital to Risk-Weighted Assets of

4.5% and a Common Equity Tier 1 Capital conservation buffer of 2.5% of risk-weighted assets. The conservation buffer will be phased in from 2016 through 2019. The rule also, among other things, raises the minimum ratio of Tier 1 Capital to Risk-Weighted Assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations.

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

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

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On August 13, 2014, the Board of Directors of First National Corporation declared a quarterly dividend of $0.025 per common share, which is payable on September 19, 2014 to shareholders of record as of September 5, 2014.

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, 2013.

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 $60.5 million at June 30, 2014, and $59.1 million at December 31, 2013, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management s credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and might not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At June 30, 2014 and December 31, 2013, the Bank had $8.7 million and $7.6 million in outstanding standby letters of credit, respectively.

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 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, 2014 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.

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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, 2013.

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:

10.1	Employment Agreement, dated May 20, 2014, by and between First National Corporation and Scott C. Harvard, attached as Exhibit 10.1 to the Current Report on Form 8-K filed May 22, 2014 and incorporated by reference herein.
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, 2014 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (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	August 14, 2014
Scott C. Harvard	Date
President and Chief Executive Officer	
/s/ M. Shane Bell	August 14, 2014
M. Shane Bell	Date
Executive Vice President and Chief Financial Officer	

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EXHIBIT INDEX

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