

FIRST NATIONAL CORP /VA/  
Form 10-Q  
May 13, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2008

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)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large 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 smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 12, 2008, 2,922,860 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

**Table of Contents**

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Income</u>	4
<u>Consolidated Statements of Cash Flows</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	7
<u>Notes to Consolidated Financial Statements</u>	8
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
Item 4(T). <u>Controls and Procedures</u>	25
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	26
Item 1A. <u>Risk Factors</u>	26
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
Item 3. <u>Defaults upon Senior Securities</u>	26
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	26
Item 5. <u>Other Information</u>	26
Item 6. <u>Exhibits</u>	26

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

	(unaudited)	
	March 31, 2008	December 31, 2007
<b>Assets</b>		
Cash and due from banks	\$ 8,950	\$ 10,680
Interest-bearing deposits in banks	2,063	2,229
Securities available for sale, at fair value	57,017	57,503
Loans held for sale	678	270
Loans, net of allowance for loan losses, 2008, \$4,473, 2007, \$4,207	440,075	445,380
Premises and equipment, net	20,470	19,405
Interest receivable	2,271	2,227
Other assets	4,011	3,871
 Total assets	 \$ 535,535	 \$ 541,565
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 83,637	\$ 78,474
Savings and interest-bearing demand deposits	172,970	177,676
Time deposits	183,421	188,992
 Total deposits	 \$ 440,028	 \$ 445,142
Federal funds purchased	3,261	3,409
Other borrowings	40,532	40,564
Company obligated mandatorily redeemable capital securities	9,279	12,372
Accrued expenses and other liabilities	3,060	2,219
Commitments and contingencies		
 Total liabilities	 \$ 496,160	 \$ 503,706
<b>Shareholders Equity</b>		
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2,922,860 shares	\$ 3,653	\$ 3,653
Surplus	1,453	1,453
Retained earnings	34,319	33,311
Unearned ESOP shares	(352)	(379)

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Accumulated other comprehensive gain (loss), net	302	(179)
Total shareholders' equity	\$ 39,375	\$ 37,859
Total liabilities and shareholders' equity	\$ 535,535	\$ 541,565

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2008 and 2007

*(in thousands, except per share data)*

	(unaudited) March 31, 2008	(unaudited) March 31, 2007
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 7,718	\$ 7,953
Interest on federal funds sold	6	14
Interest on deposits in banks	18	25
Interest and dividends on securities available for sale:		
Taxable interest	515	535
Tax-exempt interest	133	115
Dividends	50	47
<b>Total interest and dividend income</b>	<b>\$ 8,440</b>	<b>\$ 8,689</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 3,033	\$ 3,542
Interest on federal funds purchased	19	39
Interest on company obligated mandatorily redeemable capital securities	223	236
Interest on other borrowings	513	550
<b>Total interest expense</b>	<b>\$ 3,788</b>	<b>\$ 4,367</b>
Net interest income	\$ 4,652	\$ 4,322
Provision for loan losses	270	
Net interest income after provision for loan losses	\$ 4,382	\$ 4,322
<b>Noninterest Income</b>		
Service charges	\$ 698	\$ 619
Fees for other customer services	436	351
Trust and asset management fees	231	225
Gains on sale of loans	37	73
Other operating income	98	22
<b>Total noninterest income</b>	<b>\$ 1,500</b>	<b>\$ 1,290</b>
<b>Noninterest Expense</b>		
Salaries and employee benefits	\$ 2,103	\$ 1,866
Occupancy	250	246
Equipment	347	318

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Marketing	106	128
Stationery and supplies	111	107
Legal and professional fees	173	168
ATM and check card	147	118
Other operating expense	580	588
<b>Total noninterest expense</b>	<b>\$ 3,817</b>	<b>\$ 3,539</b>
Income before income taxes	\$ 2,065	\$ 2,073
Provision for income taxes	650	670
<b>Net income</b>	<b>\$ 1,415</b>	<b>\$ 1,403</b>
<b>Earnings per common share, basic and diluted</b>	<b>\$ 0.49</b>	<b>\$ 0.48</b>

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2008 and 2007

*(in thousands)*

	(unaudited) March 31, 2008	(unaudited) March 31, 2007
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 1,415	\$ 1,403
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Depreciation and amortization	288	278
Provision for loan losses	270	
Origination of loans held for sale	(3,947)	(5,987)
Proceeds from sale of loans available for sale	3,576	6,061
Gains on sale of loans	(37)	(73)
Accretion of security discounts	(13)	(9)
Amortization of security premiums	23	28
Shares acquired by leveraged ESOP	27	24
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(44)	47
(Increase) decrease in other assets	(139)	14
Increase in accrued expenses and other liabilities	592	419
Net cash provided by operating activities	\$ 2,011	\$ 2,205
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$ 180	\$ 652
Proceeds from maturities, calls, and principal payments of securities available for sale	2,143	1,886
Purchase of securities available for sale	(1,118)	(3,205)
Decrease in federal funds sold		4,159
Purchase of premises and equipment	(1,353)	(984)
Net (increase) decrease in loans	5,035	(1,411)
Net cash provided by investing activities	\$ 4,887	\$ 1,097
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 457	\$ 14,259
Net (decrease) in time deposits	(5,571)	(14,487)
Proceeds from other borrowings	10,000	74,500
Principal payments on other borrowings	(10,032)	(79,529)
Principal payments on company obligated mandatorily redeemable capital securities	(3,093)	
Cash dividends paid	(407)	(377)
Decrease in federal funds purchased	(148)	
Net cash used in financing activities	\$ (8,794)	\$ (5,634)
Decrease in cash and cash equivalents	\$ (1,896)	\$ (2,332)
<b>Cash and Cash Equivalents</b>		
Beginning	12,909	12,127



Ending	\$ 11,013	\$ 9,795
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*See Notes to Consolidated Financial Statements*

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

(Continued)

Three months ended March 31, 2008 and 2007

*(in thousands)*

	<b>(unaudited)</b> <b>March 31,</b> <b>2008</b>	<b>(unaudited)</b> <b>March 31,</b> <b>2007</b>
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 3,874	\$ 4,469
Income taxes	\$ 934	\$
<b>Supplemental Disclosures of Noncash Investing Activities</b>		
Unrealized gain on securities available for sale	\$ 728	\$ 95

*See Notes to Consolidated Financial Statements*

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

Three months ended March 31, 2008 and 2007

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

	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
<b>Balance, December 31, 2006</b>	\$ 3,653	\$ 1,465	\$ 29,104	\$ (546)	\$ (1,121)		\$ 32,555
Comprehensive income:							
Net income			1,403			\$ 1,403	1,403
Other comprehensive income, net of tax:							
Unrealized holding gains arising during the period (net of tax, \$32)					63	63	63
Total comprehensive income						\$ 1,466	
Shares acquired by leveraged ESOP				24			24
Cash dividends (\$0.13 per share)			(377)				(377)
<b>Balance, March 31, 2007</b>	\$ 3,653	\$ 1,465	\$ 30,130	\$ (522)	\$ (1,058)		\$ 33,668

	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
<b>Balance, December 31, 2007</b>	\$ 3,653	\$ 1,453	\$ 33,311	\$ (379)	\$ (179)		\$ 37,859
Comprehensive income:							
Net income			1,415			\$ 1,415	1,415
Other comprehensive income, net of tax:							
Unrealized holding gains arising during the period (net of tax, \$247)					481	481	481
Total comprehensive income						\$ 1,896	

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Shares acquired by leveraged ESOP						27		27
Cash dividends (\$0.14 per share)						(407)		(407)
<b>Balance, March 31, 2008</b>	\$ 3,653	\$ 1,453	\$ 34,319	\$ (352)	\$ 302			\$ 39,375

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its 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 consisting of a normal and recurring nature considered necessary to present fairly the financial positions at March 31, 2008 and December 31, 2007, the results of operations for the three months ended March 31, 2008 and 2007 and cash flows and changes in shareholders' equity for the three months ended March 31, 2008 and 2007. 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, 2007. Operating results for the three month period ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and restricted securities. Restricted securities include required equity investments in certain correspondent banks. All of the Company's securities were classified as available for sale at March 31, 2008 and December 31, 2007. Amortized costs and fair values were as follows:

	<i>(in thousands)</i>			
	March 31, 2008			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 38,481	\$ 841	\$ (36)	\$ 39,286
Obligations of states and political subdivisions	14,061	241	(30)	14,272
Corporate equity securities	13	134		147
Restricted securities	3,312			3,312
	\$ 55,867	\$ 1,216	\$ (66)	\$ 57,017

	<i>(in thousands)</i>			
	December 31, 2007			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 40,348	\$ 277	\$ (168)	\$ 40,457
Obligations of states and political subdivisions	13,334	125	(36)	13,423
Corporate equity securities	13	224		237
Restricted securities	3,386			3,386

\$ 57,081    \$    626    \$    (204)    \$ 57,503

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

At March 31, 2008 and December 31, 2007, investments in an unrealized loss position that were temporarily impaired were as follows:

	<i>(in thousands)</i>					
	March 31, 2008		March 31, 2008		Total	
	Less than 12 months Fair Value	Unrealized (Loss)	12 months or more Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$	\$	\$ 1,587	\$ (36)	\$ 1,587	\$ (36)
Obligations of states and political subdivisions	2,606	(30)			2,606	(30)
	\$ 2,606	\$ (30)	\$ 1,587	\$ (36)	\$ 4,193	\$ (66)

	<i>(in thousands)</i>					
	December 31, 2007		December 31, 2007		Total	
	Less than 12 months Fair Value	Unrealized (Loss)	12 months or more Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$	\$	\$ 12,606	\$ (168)	\$ 12,206	\$ (168)
Obligations of states and political subdivisions	1,575	(21)	1,544	(15)	3,119	(36)
	\$ 1,575	\$ (21)	\$ 13,750	\$ (183)	\$ 15,325	\$ (204)

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. All of the securities with unrealized losses are considered temporarily impaired and are a result of interest rate factors. These securities have not suffered credit deterioration and the Company has the ability and intent to hold these issues until maturity. At March 31, 2008, there were two U.S. agency and mortgage-backed securities and six obligations of state and political subdivisions in an unrealized loss position. Ninety-two percent of the Company's investment portfolio had AAA credit ratings with a weighted-average repricing term of 3.8 years at March 31, 2008.

**Note 3. Loans**

Loans at March 31, 2008 and December 31, 2007 are summarized as follows:

	<i>(in thousands)</i>	
	March 31, 2008	December 31, 2007
Mortgage loans on real estate:		
Construction	\$ 72,062	\$ 73,478

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Secured by farm land	1,765	1,789
Secured by 1-4 family residential	106,481	106,378
Other real estate loans	191,003	192,616
Loans to farmers (except those secured by real estate)	2,108	2,144
Commercial and industrial loans (except those secured by real estate)	53,052	53,028
Consumer loans	17,294	18,363
Deposit overdrafts	188	415
All other loans	595	1,376
Total loans	\$ 444,548	\$ 449,587
Allowance for loan losses	4,473	4,207
Loans, net	\$ 440,075	\$ 445,380



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

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$371.3 million, or 83.5% of total loans and \$374.3 million, or 83.2% of loans, net of the allowance for loan losses, at March 31, 2008 and December 31, 2007, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be affected by local economic conditions. Construction loans totaled \$72.1 million and \$73.5 million, or 16.2% and 16.3% of total loans at March 31, 2008 and December 31, 2007, respectively.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$43.2 million at March 31, 2008, representing 109.8% of total shareholders' equity and 9.7% of total loans. At December 31, 2007, this concentration totaled \$43.4 million representing 114.7% of total shareholders' equity and 9.6% of total loans. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this concentration of credit risk during the three month period ended March 31, 2008 and the year ended December 31, 2007.

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the three months ended March 31, 2008 and 2007 and for the year ended December 31, 2007 were as follows:

	<i>(in thousands)</i>		
	<b>March 31, 2008</b>	<b>December 31, 2007</b>	<b>March 31, 2007</b>
Balance at beginning of year	\$ 4,207	\$ 3,978	\$ 3,978
Provision charged to operating expense	270	398	
Loan recoveries	73	213	56
Loan charge-offs	(77)	(382)	(72)
<b>Balance at end of period</b>	<b>\$ 4,473</b>	<b>\$ 4,207</b>	<b>\$ 3,962</b>

Impaired loans of \$7.2 million at March 31, 2008 and \$3.3 million December 31, 2007 have been recognized in conformity with SFAS No. 114. The related allowance for loan losses provided for these loans totaled \$99 thousand and \$12 thousand at March 31, 2008 and December 31, 2007, respectively. The average recorded investment in impaired loans during the three months ended March 31, 2008 and the year ended December 31, 2007 was \$3.7 million and \$952 thousand, respectively.

**Note 5. Other Borrowings**

The Bank had unused lines of credit totaling \$79.8 million available with non-affiliated banks at March 31, 2008. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets.

At March 31, 2008, the Bank had borrowings from the FHLB system totaling \$40.0 million which mature through March 17, 2011. The interest rate on these notes payable ranged from 2.44% to 5.26% and the weighted average rate was 4.49%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$46.0 million at March 31, 2008 and FHLB stock and other investment securities with a book value of \$24.4 million at March 31, 2008.

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At March 31, 2008, the Bank had a \$180 thousand note payable, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%. The Company also had an unsecured note payable of \$352 thousand, which requires monthly payments of \$11 thousand and matures September 12, 2011. The fixed interest rate on this loan is 7.35%.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 6. Capital Requirements**

A comparison of the capital of the Company and the Bank at March 31, 2008 and December 31, 2007 with the minimum regulatory guidelines were as follows:

	<i>(dollars in thousands)</i>				<b>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions</b>	
	<b>Actual</b>		<b>Minimum Capital Requirement</b>		<b>Amount</b>	<b>Ratio</b>
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>		
<b>March 31, 2008:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 53,104	11.49%	\$ 36,979	8.00%	N/A	N/A
First Bank	\$ 52,290	11.34%	\$ 36,899	8.00%	\$ 46,123	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 48,631	10.52%	\$ 18,489	4.00%	N/A	N/A
First Bank	\$ 47,817	10.37%	\$ 18,449	4.00%	\$ 27,674	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 48,631	9.03%	\$ 21,554	4.00%	N/A	N/A
First Bank	\$ 47,817	8.89%	\$ 21,514	4.00%	\$ 26,893	5.00%
<b>December 31, 2007:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 54,922	11.80%	\$ 37,250	8.00%	N/A	N/A
First Bank	\$ 54,136	11.64%	\$ 37,196	8.00%	\$ 46,496	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 50,715	10.89%	\$ 18,625	4.00%	N/A	N/A
First Bank	\$ 49,929	10.74%	\$ 18,598	4.00%	\$	