FIRST NATIONAL CORP /VA/
Form 10-Q
August 16, 2010
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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, 2010**

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

**(540) 465-9121**

**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ 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 13, 2010, 2,940,776 shares of common stock, par value $1.25 per share, of the registrant were outstanding.

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## PART I FINANCIAL INFORMATION

**Item 1. Financial Statements**

## FIRST NATIONAL CORPORATION

### Consolidated Balance Sheets

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

| | (unaudited) June 30, 2010 | December 31, 2009 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 6,852 | $ 6,100 |
| Interest-bearing deposits in banks | 5,231 | 8,877 |
| Securities available for sale, at fair value | 54,757 | 60,129 |
| Restricted securities, at cost | 3,426 | 3,426 |
| Loans held for sale | | 210 |
| Loans, net of allowance for loan losses, 2010, $7,634, 2009, $7,106 | 434,860 | 436,129 |
| Premises and equipment, net | 20,157 | 21,148 |
| Interest receivable | 1,697 | 1,710 |
| Other real estate owned, net of valuation allowance, 2010, $742, 2009, $994 | 7,253 | 6,261 |
| Other assets | 9,488 | 8,684 |
| Total assets | $ 543,721 | $ 552,674 |
| **Liabilities and Shareholders Equity** | | |
| **Liabilities** | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | $ 82,665 | $ 81,101 |
| Savings and interest-bearing demand deposits | 156,914 | 146,056 |
| Time deposits | 202,536 | 236,729 |
| Total deposits | $ 442,115 | $ 463,886 |
| Federal funds purchased | 13,304 | |
| Other borrowings | 20,133 | 20,186 |
| Company obligated mandatorily redeemable capital securities | 9,279 | 9,279 |
| Accrued expenses and other liabilities | 3,126 | 4,516 |
| Commitments and contingencies | | |
| Total liabilities | $ 487,957 | $ 497,867 |
| **Shareholders Equity** | | |
| Preferred stock, $1,000 liquidation preference; 14,595 shares issued and outstanding | $ 14,062 | $ 13,998 |
| | 3,676 | 3,664 |

| | | |
|---|---|---|
| Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2010, 2,940,776 shares, 2009, 2,931,721 shares | | |
| Surplus | 1,487 | 1,418 |
| Retained earnings | 35,607 | 35,104 |
| Unearned ESOP shares | | (42) |
| Accumulated other comprehensive income, net | 932 | 665 |
| Total shareholders equity | $ 55,764 | $ 54,807 |
| Total liabilities and shareholders equity | $ 543,721 | $ 552,674 |

See Notes to Consolidated Financial Statements

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**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Income**

**Three months ended June 30, 2010 and 2009**

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

| | (unaudited) June 30, 2010 | (unaudited) June 30, 2009 |
|---|---|---|
| **Interest and Dividend Income** | | |
| Interest and fees on loans | $ 6,229 | $ 6,074 |
| Interest on federal funds sold | | 2 |
| Interest on deposits in banks | 2 | |
| Interest and dividends on securities available for sale: | | |
| Taxable interest | 432 | 520 |
| Tax-exempt interest | 142 | 143 |
| Dividends | 16 | 10 |
| Total interest and dividend income | $ 6,821 | $ 6,749 |
| **Interest Expense** | | |
| Interest on deposits | $ 1,501 | $ 1,968 |
| Interest on federal funds purchased | 6 | 1 |
| Interest on company obligated mandatorily redeemable capital securities | 109 | 121 |
| Interest on other borrowings | 103 | 188 |
| Total interest expense | $ 1,719 | $ 2,278 |
| Net interest income | $ 5,102 | $ 4,471 |
| Provision for loan losses | 1,000 | 489 |
| Net interest income after provision for loan losses | $ 4,102 | $ 3,982 |
| **Noninterest Income** | | |
| Service charges on deposit accounts | $ 682 | $ 629 |
| ATM and check card fees | 366 | 306 |
| Trust and investment advisory fees | 294 | 281 |
| Fees for other customer services | 91 | 71 |
| Gains on sale of loans | 25 | 69 |
| Gains on sale of securities available for sale | | 4 |
| Gains on sale of premises and equipment | | 9 |
| Other operating income | 31 | 40 |
| Total noninterest income | $ 1,489 | $ 1,409 |

| | | | | |
|---|---|---|---|---|
| **Noninterest Expense** | | | | |
| Salaries and employee benefits | $ | 2,290 | $ | 2,206 |
| Occupancy | | 351 | | 320 |
| Equipment | | 343 | | 362 |
| Marketing | | 128 | | 134 |
| Stationery and supplies | | 85 | | 148 |
| Legal and professional fees | | 194 | | 211 |
| ATM and check card fees | | 209 | | 201 |
| FDIC assessment | | 184 | | 337 |
| Bank franchise tax | | 109 | | 82 |
| Provision for other real estate owned | | 40 | | 575 |
| Other operating expense | | 592 | | 533 |
| Total noninterest expense | $ | 4,525 | $ | 5,109 |
| Income before income taxes | $ | 1,066 | $ | 282 |
| Income tax provision | | 313 | | 45 |
| **Net income** | $ | 753 | $ | 237 |
| Effective dividend and accretion on preferred stock | | 221 | | 220 |
| **Net income available to common shareholders** | $ | 532 | $ | 17 |
| **Earnings per common share, basic and diluted** | $ | 0.18 | $ | 0.01 |

See Notes to Consolidated Financial Statements

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**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Income**

**Six months ended June 30, 2010 and 2009**

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

| | (unaudited) June 30, 2010 | (unaudited) June 30, 2009 |
|---|---|---|
| **Interest and Dividend Income** | | |
| Interest and fees on loans | $ 12,489 | $ 12,135 |
| Interest on federal funds sold | | 4 |
| Interest on deposits in banks | 4 | |
| Interest and dividends on securities available for sale: | | |
| Taxable interest | 900 | 1,029 |
| Tax-exempt interest | 287 | 282 |
| Dividends | 28 | 16 |
| Total interest and dividend income | $ 13,708 | $ 13,466 |
| **Interest Expense** | | |
| Interest on deposits | $ 3,177 | $ 4,109 |
| Interest on federal funds purchased | 11 | 9 |
| Interest on company obligated mandatorily redeemable capital securities | 217 | 248 |
| Interest on other borrowings | 252 | 436 |
| Total interest expense | $ 3,657 | $ 4,802 |
| Net interest income | $ 10,051 | $ 8,664 |
| Provision for loan losses | 1,411 | 1,660 |
| Net interest income after provision for loan losses | $ 8,640 | $ 7,004 |
| **Noninterest Income** | | |
| Service charges on deposit accounts | $ 1,291 | $ 1,183 |
| ATM and check card fees | 680 | 575 |
| Trust and investment advisory fees | 604 | 589 |
| Fees for other customer services | 164 | 145 |
| Gains on sale of loans | 65 | 108 |
| Gains on sale of securities available for sale | 2 | 10 |
| Gains on sale of premises and equipment | | 9 |
| Losses on sale of other real estate owned, net | (52) | |
| Other operating income | 56 | 17 |
| Total noninterest income | $ 2,810 | $ 2,636 |

| | | |
|---|---|---|
| **Noninterest Expense** | | |
| Salaries and employee benefits | $ 4,517 | $ 4,412 |
| Occupancy | 695 | 651 |
| Equipment | 691 | 697 |
| Marketing | 252 | 269 |
| Stationery and supplies | 182 | 295 |
| Legal and professional fees | 420 | 391 |
| ATM and check card fees | 386 | 371 |
| FDIC assessment | 371 | 429 |
| Bank franchise tax | 209 | 167 |
| Provision for other real estate owned | 40 | 635 |
| Other operating expense | 1,159 | 1,055 |
| Total noninterest expense | $ 8,922 | $ 9,372 |
| Income before income taxes | $ 2,528 | $ 268 |
| Income tax provision (benefit) | 760 | (6) |
| **Net income** | $ 1,768 | $ 274 |
| Effective dividend and accretion on preferred stock | 443 | 264 |
| **Net income available to common shareholders** | $ 1,325 | $ 10 |
| **Earnings per common share, basic and diluted** | $ 0.45 | $ 0.00 |

See Notes to Consolidated Financial Statements

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**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Cash Flows**

**Six months ended June 30, 2010 and 2009**

**(in thousands)**

| | (unaudited) June 30, 2010 | (unaudited) June 30, 2009 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $ 1,768 | $ 274 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 623 | 639 |
| Origination of loans held for sale | (4,626) | (9,435) |
| Proceeds from sale of loans available for sale | 4,901 | 8,737 |
| Gains on sale of loans | (65) | (108) |
| Provision for loan losses | 1,411 | 1,660 |
| Provision for other real estate owned | 40 | 635 |
| Gains on sale of securities available for sale | (2) | (10) |
| Gains on sale of premises and equipment | | (9) |
| Losses on sale of other real estate owned, net | 52 | |
| Accretion of security discounts | (21) | (39) |
| Amortization of security premiums | 185 | 98 |
| Shares acquired by leveraged ESOP | 42 | 86 |
| Changes in assets and liabilities: | | |
| Decrease in interest receivable | 13 | 79 |
| Increase in other assets | (310) | (584) |
| Increase (decrease) in accrued expenses and other liabilities | (1,527) | 251 |
| Net cash provided by operating activities | $ 2,484 | $ 2,274 |
| **Cash Flows from Investing Activities** | | |
| Proceeds from sales of securities available for sale | $ | $ 2,070 |
| Proceeds from maturities, calls, and principal payments of securities available for sale | 5,615 | 8,405 |
| Purchase of securities available for sale | | (16,550) |
| Increase in federal funds sold | | (1,871) |
| Proceeds from sale of premises and equipment | | 225 |
| Purchase of premises and equipment | (125) | (442) |
| Proceeds from sale of other real estate owned | 1,779 | 94 |
| Net (increase) decrease in loans | (3,007) | 3,956 |
| Net cash provided by (used in) investing activities | $ 4,262 | $ (4,113) |
| **Cash Flows from Financing Activities** | | |
| Net increase in demand deposits and savings accounts | $ 12,422 | $ 2,112 |
| Net increase (decrease) in time deposits | (34,193) | 11,850 |

| | | |
|---|---|---|
| Proceeds from other borrowings | 23,601 | 31,000 |
| Principal payments on other borrowings | (23,654) | (56,096) |
| Proceeds from issuance of preferred stock | | 13,900 |
| Cash dividends paid on common stock | (715) | (817) |
| Cash dividends paid on preferred stock | (379) | (130) |
| Increase (decrease) in federal funds purchased | 13,304 | (2,456) |
| Shares issued to leveraged ESOP | (26) | (40) |
| Net cash used in financing activities | $ (9,640) | $ (677) |
| Decrease in cash and cash equivalents | $ (2,894) | $ (2,516) |
| **Cash and Cash Equivalents** | | |
| Beginning | $ 14,977 | $ 10,490 |
| Ending | $ 12,083 | $ 7,974 |

See Notes to Consolidated Financial Statements

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**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Cash Flows**

**(Continued)**

**Six months ended June 30, 2010 and 2009**

**(in thousands)**

| | (unaudited) June 30, 2010 | (unaudited) June 30, 2009 |
|---|---|---|
| **Supplemental Disclosures of Cash Flow Information** | | |
| Cash payments for: | | |
| Interest | $ 3,836 | $ 4,893 |
| Income taxes | $ 2,541 | $ 75 |
| **Supplemental Disclosures of Noncash Investing and Financing Activities** | | |
| Unrealized gain (loss) on securities available for sale | $ 405 | $ (131) |
| Transfer from loans to other real estate | $ 2,865 | $ 1,659 |
| Issuance of common stock, dividend reinvestment plan | $ 107 | $ |

See Notes to Consolidated Financial Statements

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**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Changes in Shareholders Equity**

**Six months ended June 30, 2010 and 2009**

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

**(unaudited)**

| | Preferred Stock | Common Stock | Surplus | Retained Earnings | Unearned ESOP Shares | Accumulated Other Comprehensive Income (Loss) | Comprehensive Income | Total |
|---|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2008** | $ | $ 3,653 | $ 1,409 | $ 35,196 | $ (232) | $ (841) | | $ 39,185 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 274 | | | $ 274 | 274 |
| Other comprehensive loss, net of tax: | | | | | | | | |
| Unrealized holding losses arising during the period (net of tax, $42) | | | | | | | (79) | |
| Reclassification adjustment (net of tax, $3) | | | | | | | (7) | |
| Other comprehensive loss (net of tax, $45) | | | | | | (86) | $ (86) | (86) |
| Total comprehensive income | | | | | | | $ 188 | |
| Shares acquired by leveraged ESOP | | | (40) | | 86 | | | 46 |
| Cash dividends on common stock ($0.28 per share) | | | | (817) | | | | (817) |
| Issuance of 13,900 shares of preferred stock | 13,900 | | | | | | | 13,900 |
| Cash dividends on preferred stock | | | | (130) | | | | (130) |
| Accretion on preferred stock discount | 37 | | | (37) | | | | |
| **Balance, June 30, 2009** | $ 13,937 | $ 3,653 | $ 1,369 | $ 34,486 | $ (146) | $ (927) | | $ 52,372 |

| | Preferred Stock | Common Stock | Surplus | Retained Earnings | Unearned ESOP Shares | Accumulated Other Comprehensive Income | Comprehensive Income | Total |
|---|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2009** | $ 13,998 | $ 3,664 | $ 1,418 | $ 35,104 | $ (42) | $ 665 | | $ 54,807 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 1,768 | | | $ 1,768 | 1,768 |
| Other comprehensive income, net of tax: | | | | | | | | |
| Unrealized holding gains arising during the period (net of tax, $139) | | | | | | | 268 | |
| Reclassification adjustment (net of tax, $1) | | | | | | | (1) | |
| Other comprehensive income (net of tax, $138) | | | | | | 267 | $ 267 | 267 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total comprehensive income | | | | | | | $ 2,035 | |
| Shares acquired by leveraged ESOP | | | (26) | | 42 | | | 16 |
| Cash dividends on common stock ($0.28 per share) | | | | (822) | | | | (822) |
| Issuance of 9,055 shares common stock, dividend reinvestment plan | | 12 | 95 | | | | | 107 |
| Cash dividends on preferred stock | | | | (379) | | | | (379) |
| Accretion on preferred stock discount | 64 | | | (64) | | | | |
| **Balance, June 30, 2010** | $ 14,062 | $ 3,676 | $ 1,487 | $ 35,607 | $ | $ 932 | | $ 55,764 |

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, 2010 and December 31, 2009, the results of operations for the three and six months ended June 30, 2010 and 2009 and cash flows and changes in shareholders equity for the six months ended June 30, 2010 and 2009. 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, 2009. Operating results for the three and six month periods ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

**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 which have no readily determinable market value. Amortized costs and fair values of securities available for sale at June 30, 2010 and December 31, 2009 were as follows:

| | (in thousands) June 30, 2010 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
| U.S. agency and mortgage-backed securities | $ 37,385 | $ 1,873 | $ | $ 39,258 |
| Obligations of states and political subdivisions | 15,043 | 404 | (129) | 15,318 |
| Corporate equity securities | 19 | 162 | | 181 |
| | $ 52,447 | $ 2,439 | $ (129) | $ 54,757 |

| | (in thousands) December 31, 2009 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
| U.S. agency and mortgage-backed securities | $ 42,654 | $ 1,593 | $ (32) | $ 44,215 |
| Obligations of states and political subdivisions | 15,551 | 326 | (171) | 15,706 |
| Corporate equity securities | 19 | 189 | | 208 |
| | $ 58,224 | $ 2,108 | $ (203) | $ 60,129 |

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

At June 30, 2010 and December 31, 2009, investments in an unrealized loss position that were temporarily impaired were as follows:

| | (in thousands) June 30, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized (Loss) | Fair Value | Unrealized (Loss) | Fair Value | Unrealized (Loss) |
| U.S. agency and mortgage-backed securities | $ | $ | $ | $ | $ | $ |
| Obligations of states and political subdivisions | 607 | (3) | 1,809 | (126) | 2,416 | (129) |
| | $ 607 | $ (3) | $ 1,809 | $ (126) | $ 2,416 | $ (129) |

| | (in thousands) December 31, 2009 | | | | | |
|---|---|---|---|---|---|---|
| | 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 | $ 2,101 | $ (32) | $ | $ | $ 2,101 | $ (32) |
| Obligations of states and political subdivisions | 1,558 | (17) | 1,785 | (154) | 3,343 | (171) |
| | $ 3,659 | $ (49) | $ 1,785 | $ (154) | $ 5,444 | $ (203) |

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

During the first six months of 2010, there were no obligations of state and political subdivisions that experienced a rating downgrade. There were four obligations of state and political subdivisions that were no longer receiving ratings by Moody s or S&P. This was the direct result of downgrades of the insurers of these bonds. For the four obligations of state and political subdivisions totaling $1.5 million that are no longer rated, the Company evaluates the financial condition of the state and political subdivision on a regular basis. At June 30, 2010, there were no U.S. agency and mortgage-backed securities and six obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company s investment portfolio that is rated is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.1 years at June 30, 2010.

The Company s investment in FHLB stock totaled $2.6 million at June 30, 2010. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at June 30, 2010, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.

**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

**Note 3. Loans**

Loans at June 30, 2010 and December 31, 2009 are summarized as follows:

| | (in thousands) | |
|---|---|---|
| | **June 30, 2010** | **December 31, 2009** |
| Mortgage loans on real estate: | | |
| Construction | $ 52,785 | $ 55,057 |
| Secured by farm land | 6,128 | 1,281 |
| Secured by 1-4 family residential | 122,612 | 118,675 |
| Other real estate loans | 203,800 | 200,001 |
| Loans to farmers (except those secured by real estate) | 3,478 | 3,530 |
| Commercial and industrial loans (except those secured by real estate) | 39,717 | 48,746 |
| Consumer loans | 12,737 | 13,619 |
| Deposit overdrafts | 290 | 157 |
| All other loans | 947 | 2,169 |
| Total loans | $ 442,494 | $ 443,235 |
| Allowance for loan losses | 7,634 | 7,106 |
| Loans, net | $ 434,860 | $ 436,129 |

The Company has a credit concentration of loans secured by real estate. These loans totaled $385.3 million, or 87% of total loans, and $375.0 million, or 85% of total loans, at June 30, 2010 and December 31, 2009, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be impacted by local economic conditions. Construction loans totaled $52.8 million and $55.1 million, or 12% of total loans at June 30, 2010 and December 31, 2009, respectively.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled $42.3 million at June 30, 2010, representing 76% of total equity and 10% of total loans. At December 31, 2009, this concentration totaled $42.9 million representing 78% of total equity and 10% 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 six month period ended June 30, 2010 and the year ended December 31, 2009.

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the six months ended June 30, 2010 and 2009 and for the year ended December 31, 2009 were as follows:

| | (in thousands) | | |
|---|---|---|---|
| | June 30, 2010 | December 31, 2009 | June 30, 2009 |
| Balance at beginning of year | $ 7,106 | $ 5,650 | $ 5,650 |
| Provision charged to operating expense | 1,411 | 2,300 | 1,660 |
| Loan recoveries | 134 | 298 | 170 |
| Loan charge-offs | (1,017) | (1,142) | (453) |
| Balance at end of period | $ 7,634 | $ 7,106 | $ 7,027 |

Impaired loans totaled $20.3 million at June 30, 2010 and $8.1 million at December 31, 2009. The related allowance for loan losses provided for these loans totaled $1.4 million and $1.5 million at June 30, 2010 and December 31, 2009, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2010 and the year ended December 31, 2009 was $18.0 million and $11.2 million, respectively.

**Note 5. Other Borrowings**

The Bank had unused lines of credit totaling $109.9 million available with non-affiliated banks at June 30, 2010. 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.

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

At June 30, 2010, the Bank had borrowings from the FHLB system totaling $20.0 million which mature through March 28, 2013. The interest rate on these notes payable ranged from 1.25% to 2.44% and the weighted average rate was 2.01%. The Bank had collateral pledged on these borrowings, including real estate loans totaling $66.5 million and FHLB stock and other investment securities with a book value of $18.1 million.

At June 30, 2010, the Bank had a $133 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%.

**Note 6. Capital Requirements**

A comparison of the capital of the Company and the Bank at June 30, 2010 and December 31, 2009 with the minimum regulatory guidelines were as follows:

| | (dollars in thousands) | | | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Actual | | Minimum Capital Requirement | | | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2010: | | | | | | |
| Total Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 69,560 | 15.10% | $ 36,863 | 8.00% | N/A | N/A |
| First Bank | $ 68,938 | 15.00% | $ 36,761 | 8.00% | $ 45,951 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 63,777 | 13.84% | $ 18,431 | 4.00% | N/A | N/A |
| First Bank | $ 63,171 | 13.75% | $ 18,381 | 4.00% | $ 27,571 | 6.00% |
| Tier 1 Capital (to Average Assets): | | | | | | |
| Consolidated | $ 63,777 | 11.72% | $ 21,764 | 4.00% | N/A | N/A |
| First Bank | $ 63,171 | 11.62% | $ 21,746 | 4.00% | $ 27,183 | 5.00% |
| December 31, 2009: | | | | | | |
| Total Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 68,892 | 14.96% | $ 36,848 | 8.00% | N/A | N/A |
| First Bank | $ 68,296 | 14.84% | $ 36,815 | 8.00% | $ 46,019 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 63,118 | 13.70% | $ 18,424 | 4.00% | N/A | N/A |
| First Bank | $ 62,527 | 13.59% | $ 18,408 | 4.00% | $ 27,611 | 6.00% |
| Tier 1 Capital (to Average Assets): | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Consolidated | $ 63,118 | 11.50% | $ 21,961 | 4.00% | N/A | N/A |
| First Bank | $ 62,527 | 11.37% | $ 21,995 | 4.00% | $ 27,494 | 5.00% |

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

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**Note 7. Company Obligated Mandatorily Redeemable Capital Securities**

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, 2010 was 3.14%. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began June 17, 2009. The principal asset of Trust II is $5.2 million of the Company s junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, $4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a fixed rate of interest of 7.26% until July 31, 2011. The securities then have a LIBOR-indexed floating rate of interest. The securities have a mandatory redemption date of October 1, 2036, and are subject to varying call provisions beginning October 1, 2011. The principal asset of Trust III is $4.1 million of the Company s junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

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, 2010, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital.

**Note 8. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service. 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, 2010 and 2009 were as follows:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Service cost | $ 77 | $ 76 | $ 153 | $ 153 |
| Interest cost | 71 | 68 | 142 | 135 |
| Expected return on plan assets | (78) | (57) | (156) | (114) |
| Amortization of prior service cost | 1 | 1 | 2 | 2 |

| | | | | |
|---|---|---|---|---|
| Amortization of net obligation at transition | (1) | (1) | (2) | (3) |
| Amortization of net loss | 5 | 19 | 10 | 40 |
| Net periodic benefit cost | $ 75 | $ 106 | $ 149 | $ 213 |

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2009, that it expected to contribute $298 thousand to its pension plan for the 2010 plan year. The Company did not make a contribution to the pension plan for the 2010 plan year during the first six months of 2010. The Company is planning to make the contribution for the 2010 plan year during the fourth quarter of 2010.

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. The Bank also maintains a Split Dollar Life Insurance Plan that provides life insurance coverage to insurable directors. See Note 11 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009 for additional information about the Company s benefit plans.

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

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**Note 9. 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. Shares not committed to be released under the Company s leveraged ESOP are not considered to be outstanding. See Note 11 of the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009 for additional information about the Company s leveraged ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 2,937,480 and 2,918,843 for the three months ended June 30, 2010 and 2009, respectively, and 2,935,192 and 2,918,012 for the six months ended June 30, 2010 and 2009, respectively.

**Note 10. Fair Value Measurements**

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

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

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

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 Valuation is based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3

Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires a significant management judgment or estimation.

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

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

***Securities available for sale***

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

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

The following tables present the balances of financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 and December 31, 2009.

| | | Fair Value Measurements at June 30, 2010 Using (in thousands) | | |
|---|---|---|---|---|
| **Description** | **Balance as of June 30, 2010** | **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 | $ 54,757 | $ 181 | $ 54,576 | $ |

| | | Fair Value Measurements at December 31, 2009 Using (in thousands) | | |
|---|---|---|---|---|
| **Description** | **Balance as of December 31, 2009** | **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 | $ 60,129 | $ 208 | $ 59,921 | $ |

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

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

***Loans held for sale***

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the six months ended June 30, 2010.

***Impaired Loans***

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans or the present value of expected future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of 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 fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. Any fair value adjustments to other real estate owned are recorded in the period incurred and expensed against current earnings.

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

| | | Carrying Value at June 30, 2010 (in thousands) | | |
|---|---|---|---|---|
| **Description** | **Balance as of June 30, 2010** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Assets | | | | |
| Impaired loans | $ 10,690 | $ | $ 2,044 | $ 8,646 |

| | | Carrying Value at December 31, 2009 (in thousands) | | |
|---|---|---|---|---|
| **Description** | **Balance as of December 31, 2009** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Assets | | | | |
| Impaired loans | $ 5,806 | $ | $ 5,771 | $ 35 |

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

| Description | Balance as of June 30, 2010 | Carrying Value at June 30, 2010 (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 7,253 | $ | $ 7,253 | $ |

| Description | Balance as of December 31, 2009 | Carrying Value at December 31, 2009 (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 6,261 | $ | $ 6,261 | $ |

**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

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

*Cash and Cash Equivalents*

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

*Loans*

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

*Deposit Liabilities*

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

*Accrued Interest*

The carrying amounts of accrued interest approximate fair value.

*Borrowings*

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

*Commitments and Unfunded Credits*

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

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At June 30, 2010 and December 31, 2009, fair value of loan commitments and standby letters of credit was immaterial.

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements (Continued)**

**(unaudited)**

The estimated fair values of the Company s financial instruments at June 30, 2010 and December 31, 2009 were as follows:

| | (in thousands) | | | |
|---|---|---|---|---|
| | June 30, 2010 | | December 31, 2009 | |
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| **Financial Assets** | | | | |
| Cash and short-term investments | $ 12,083 | $ 12,083 | $ 14,977 | $ 14,977 |
| Securities | 54,757 | 54,757 | 60,129 | 60,129 |
| Loans, net | 434,860 | 434,477 | 436,129 | 434,457 |
| Loans held for sale | | | 210 | 210 |
| Accrued interest receivable | 1,697 | 1,697 | 1,710 | 1,710 |
| **Financial Liabilities** | | | | |
| Deposits | $ 442,115 | $ 406,106 | $ 463,886 | $ 421,115 |
| Federal funds purchased | 13,304 | 13,306 | | |
| Other borrowings | 20,133 | 20,517 | 20,186 | 20,527 |
| Company obligated mandatorily redeemable capital securities | 9,279 | 9,625 | 9,279 | 9,784 |
| Accrued interest payable | 646 | 646 | 824 | 824 |

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

**Note 11. Capital Purchase Program**

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

**Note 12. Subsequent Events**

The Company evaluated subsequent events that have occurred after the balance sheet date, but before the financial statements were issued. There are two types of subsequent events (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

Based on the evaluation, the Company did not identify any recognized or nonrecognized subsequent events that would have required adjustment to or disclosure in the financial statements.

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

***Cautionary Statement Regarding Forward-Looking Statements***

The Company makes forward-looking statements in this Form 10-Q that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or othe terms are intended to identify forward-looking statements. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

- the Company may be adversely affected by economic conditions in the market area;
- risks inherent in the loan portfolio such as repayment risks, fluctuating collateral values and concentrations;
- the adequacy of the allowance for loan losses related to changes in general economic and business conditions in the market area;
- successful management of credit risk including certain concentrations in loans secured by real estate;
- the adequacy of the valuation allowance for other real estate owned related to changes in economic conditions and local real estate activity;
- potential impact on the Company of legislation;
- the ability to continue paying common dividends;
- difficult market conditions in the Company s industry;
- the reliance on secondary sources, such as Federal Home Loan Bank advances, sales of securities and loans, federal funds lines of credit from correspondent banks and out-of-market time deposits, to meet liquidity needs;
- the ability to raise capital as needed;
- the successful management of interest rate risk;
- the limited trading market in the Company s common stock; and
- other factors identified in Item 1A. Risk Factors of the Company s Form 10-K for the year ending December 31, 2009.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition and results of operations of the Company for the three and six month periods ended June 30, 2010 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, 2009. The results of operations for the three and six month periods ended June 30, 2010 may not be indicative of the results to be achieved for the year.

***Executive Overview***

*The Company*

First National Corporation (the Company) is the financial 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 I (Trust I)
- First National (VA) Statutory Trust II (Trust II)
- First National (VA) Statutory Trust III (Trust III)

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

*Products, Services, Customers and Locations*

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

The Bank provides loan, deposit, investment, trust and asset management and other products and services in the northern Shenandoah Valley region of Virginia. Loan products and services include personal loans (including automobile and property improvement 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, cash management and direct deposit services. The Bank offers other services, including safe deposit rentals, travelers and gift cards, internet banking, wire transfer services, remote deposit capture and other traditional banking services.

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

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The Bank s products and services are provided through 11 branch offices, 31 ATMs and its website, www.therespowerinone.com. The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank s financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank s market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2009.

*Revenue Sources and Expense Factors*

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

The provision for loan losses and noninterest expense are the other two major expense categories. The provision is determined by factors that include loan growth, asset quality, net charge-offs and economic conditions. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company s control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the six month period ended June 30, 2010 was salaries and employee benefits, comprising 51% of noninterest expenses, followed by occupancy and equipment expense, comprising 16% of noninterest expenses.

*Quarterly Performance*

Second quarter 2010 net income was $516 thousand higher than the same quarter of 2009:

Net interest income was $631 thousand higher

Provision for loan losses was $511 thousand higher

Noninterest income was $80 thousand higher

Noninterest expense was $584 thousand lower

Net income totaled $753 thousand for the quarter ended June 30, 2010 compared to $237 thousand for the same quarter in 2009. After the effective dividend and accretion on preferred stock, net income available to common shareholders was $532 thousand, or $0.18 per basic and diluted share compared to $17 thousand, or $0.01 per basic and diluted share, for the same period in 2009. The increase in second quarter 2010 earnings compared to the same period in 2009 was primarily the result of a 14% increase in net interest income and an 11% decrease in noninterest expense, offset by higher provision for loan losses. Noninterest income increased 6% when comparing the two periods. Return on assets and return on equity were 0.55% and 5.41%, respectively, for the second quarter of 2010 compared to 0.17% and 1.80% for the same quarter in 2009.

Comparing the quarter ended June 30, 2010 to the same period in 2009, net interest income increased 14% to $5.1 million. The net interest margin was 58 basis points higher and average interest-earning assets were $11.1 million lower when comparing the two periods. The net interest margin was 4.11% for the second quarter of 2010, compared to 3.53% for the same period in 2009. The improvement in the margin resulted primarily from lower funding costs. The yield on earning assets and improvements in the funding mix also contributed to the improved margin.

Higher levels of net charge-offs during the quarter and an increase to the allowance for loan losses resulted in a loan loss provision of $1.0 million in the second quarter of 2010 compared to $489 thousand for the same period in 2009. Net charge-offs were $531 thousand for the second quarter of 2010 compared to $23 thousand for the same period in 2009. The allowance for loan losses totaled $7.6 million or 1.73% of total loans at June 30, 2010, compared to $7.0 million or 1.58% of total loans at June 30, 2009. Management regularly evaluates the loan portfolio, economic conditions and other factors to determine an appropriate allowance for loan losses. As a result of those evaluations, management believes the allowance for loan losses was adequate at June 30, 2010.

Noninterest income increased 6% to $1.5 million for the second quarter of 2010 compared to $1.4 million for the same quarter of 2009. The increase in noninterest income resulted primarily from more ATM and check card and overdraft fee income. Noninterest expense decreased 11% to $4.5 million for the second quarter of 2010 compared to $5.1 million for the same quarter of 2009. The decrease in noninterest expense was primarily related to lower FDIC assessments and provisions for other real estate owned.

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*Year-to-Date Performance*

Net income was $1.5 million higher than the previous year:

- Net interest income was $1.4 million higher
- Provision for loan losses was $249 thousand lower
- Noninterest income was $174 thousand higher
- Noninterest expense was $450 thousand lower

For the six months ended June 30, 2010, net income was $1.8 million compared to $274 thousand for the same period in 2009. After the effective dividend on preferred stock, net income available to common shareholders was $1.3 million, or $0.45 per basic and diluted share, compared to $10 thousand, or $0.00 per basic and diluted share, for the same period in 2009. The increase in earnings for the six months ended June 30, 2010 was primarily the result of a 16% increase in net interest income and a 5% decrease in noninterest expense. Return on assets was 0.65% for the six months ended June 30, 2010 compared to 0.10% for the same period in 2009, and return on equity was 6.42% for the six months ended June 30, 2010 compared to 1.17% for the same period in 2009.

Net interest income increased 16% to $10.1 million for the six months ended June 30, 2010 compared to $8.7 million for the same period in 2009. The net interest margin was 61 basis points higher while average interest-earning assets were $7.5 million lower when comparing the two periods. The net interest margin was 4.06% for the six months ended June 30, 2010, compared to 3.45% for the same period in 2009.

For the six months ended June 30, 2010, the loan loss provision totaled $1.4 million compared to $1.7 million for the same period in 2009. During 2010, the provision for loan losses was a result of higher net charge-offs and an increase to the allowance for loan losses. Net charge-offs were $883 thousand for the first half of 2010 compared to $283 thousand for the same period in 2009. During 2009, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

Noninterest income increased 7% to $2.8 million for the six months ended June 30, 2010 from $2.6 million for the same period in 2009. This increase was attributable to more overdraft and ATM and check card fee income. Noninterest expense decreased 5% to $8.9 million for the six months ended June 30, 2010, compared to $9.4 million for the same period in 2009. The decrease in noninterest expense was primarily the result of lower provision for other real estate owned. The provision for other real estate owned totaled $40 thousand for the six months ended June 30, 2010 compared to $635 thousand for the same period in 2009.

*Management Outlook*

The Company expects stable net interest income and low expense growth for the remainder of 2010. Earning asset balances and the net interest margin are not expected to change significantly. Low noninterest expense growth has been forecast as the Company continues expense containment efforts to improve profitability.

Noninterest income, the provision for loan losses and the provision for other real estate owned are less predictable for future periods. The impact on noninterest income from recent overdraft protection legislation has been difficult to measure, resulting in uncertain levels of noninterest income during periods beginning in the second half of 2010. Although management is developing strategies to mitigate earnings risk related to the legislation, the Company is planning for lower noninterest income in 2010 compared to 2009.

The amount of provision for loan losses and provision for other real estate owned for future periods remains difficult to accurately forecast as the expense will be heavily influenced by charge-off levels, economic conditions and local real estate activity.

***Non-GAAP Financial Measures***

The Company measures the net interest margin as an indicator of profitability. The net interest margin is calculated by dividing tax-equ