FIRST NATIONAL CORP /VA/
Form 10-Q
November 14, 2012
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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 September 30, 2012

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 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 November 12, 2012, 4,901,464 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) September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 6,655	$ 6,314
Interest-bearing deposits in banks	19,564	23,210
Securities available for sale, at fair value	95,839	91,665
Restricted securities, at cost	1,973	2,775
Loans held for sale		274
Loans, net of allowance for loan losses, 2012, $14,049, 2011, $12,937	366,703	379,503
Other real estate owned, net of valuation allowance, 2012, $1,847, 2011, $2,792	5,323	6,374
Premises and equipment, net	19,181	19,598
Interest receivable	1,581	1,620
Other assets	4,863	7,731
Total assets	$ 521,682	$ 539,064
Liabilities and Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 83,916	$ 81,714
Savings and interest-bearing demand deposits	207,058	198,194
Time deposits	165,984	189,264
Total deposits	$ 456,958	$ 469,172
Other borrowings	6,082	19,100
Trust preferred capital notes	9,279	9,279
Other liabilities	4,540	4,417
Total liabilities	$ 476,859	$ 501,968
Shareholders Equity		
Preferred stock, $1,000 liquidation preference; 14,595 shares issued and outstanding	$ 14,372	$ 14,263
Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2012, 4,901,464 shares, 2011, 2,955,649 shares	6,127	3,695
Surplus	6,813	1,644
Retained earnings	17,683	16,503

Accumulated other comprehensive income (loss), net	(172)	991
Total shareholders equity	$ 44,823	$ 37,096
Total liabilities and shareholders equity	$ 521,682	$ 539,064

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

Three months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Interest and Dividend Income		
Interest and fees on loans	$ 5,189	$ 5,666
Interest on federal funds sold	3	2
Interest on deposits in banks	11	3
Interest and dividends on securities available for sale:		
Taxable interest	494	595
Tax-exempt interest	55	121
Dividends	19	16
Total interest and dividend income	$ 5,771	$ 6,403
Interest Expense		
Interest on deposits	$ 928	$ 1,204
Interest on trust preferred capital notes	60	109
Interest on other borrowings	47	42
Total interest expense	$ 1,035	$ 1,355
Net interest income	$ 4,736	$ 5,048
Provision for loan losses	805	5,575
Net interest income (loss) after provision for loan losses	$ 3,931	$ (527)
Noninterest Income		
Service charges on deposit accounts	$ 544	$ 590
ATM and check card fees	369	391
Trust and investment advisory fees	365	350
Fees for other customer services	78	84
Gains on sale of loans	51	25
Gains on sale of securities available for sale, net	167	
Gains on sale of premises and equipment	2	
Other operating income	33	33
Total noninterest income	$ 1,609	$ 1,473
Noninterest Expense		
Salaries and employee benefits	$ 2,398	$ 2,299

Occupancy	333	347
Equipment	294	325
Marketing	120	109
Stationery and supplies	67	88
Legal and professional fees	293	276
ATM and check card fees	161	162
FDIC assessment	176	181
Bank franchise tax	62	103
Provision for other real estate owned	26	927
Other real estate owned expense	99	133
Net gains on sale of other real estate owned	(47)	(36)
Telecommunications expense	62	63
Data processing	102	79
Other operating expense	511	332
Total noninterest expense	$ 4,657	$ 5,388

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

(Continued)

Three months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Income (loss) before income taxes	$ 883	$ (4,442)
Income tax provision (benefit)	195	(1,556)
Net income (loss)	$ 688	$ (2,886)
Effective dividend on preferred stock	226	224
Net income (loss) available to common shareholders	$ 462	$ (3,110)
Earnings (loss) per common share, basic and diluted	$ 0.09	$ (1.05)

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

Nine months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Interest and Dividend Income		
Interest and fees on loans	$ 16,001	$ 17,317
Interest on federal funds sold	12	13
Interest on deposits in banks	19	15
Interest and dividends on securities available for sale:		
Taxable interest	1,542	1,618
Tax-exempt interest	228	365
Dividends	57	50
Total interest and dividend income	$ 17,859	$ 19,378
Interest Expense		
Interest on deposits	$ 2,874	$ 3,810
Interest on trust preferred capital notes	182	327
Interest on other borrowings	192	175
Total interest expense	$ 3,248	$ 4,312
Net interest income	$ 14,611	$ 15,066
Provision for loan losses	3,455	9,395
Net interest income after provision for loan losses	$ 11,156	$ 5,671
Noninterest Income		
Service charges on deposit accounts	$ 1,569	$ 1,626
ATM and check card fees	1,129	1,172
Trust and investment advisory fees	1,079	1,076
Fees for other customer services	283	231
Gains on sale of loans	143	94
Gains on sale of securities available for sale, net	1,285	41
Gains on sale of premises and equipment	2	
Other operating income	95	58
Total noninterest income	$ 5,585	$ 4,298
Noninterest Expense		
Salaries and employee benefits	$ 7,155	$ 6,867

Occupancy	996	1,019
Equipment	907	973
Marketing	293	314
Stationery and supplies	234	254
Legal and professional fees	741	746
ATM and check card fees	480	492
FDIC assessment	533	588
Bank franchise tax	199	312
Provision for other real estate owned	595	1,103
Other real estate owned expense	450	325
Net gains on sale of other real estate owned	(297)	(28)
Telecommunications expense	184	239
Data processing	270	220
Other operating expense	1,255	1,035
Total noninterest expense	$ 13,995	$ 14,459

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

(Continued)

Nine months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Income (loss) before income taxes	$ 2,746	$ (4,490)
Income tax provision (benefit)	889	(1,662)
Net income (loss)	$ 1,857	$ (2,828)
Effective dividend on preferred stock	677	670
Net income (loss) available to common shareholders	$ 1,180	$ (3,498)
Earnings (loss) per common share, basic and diluted	$ 0.33	$ (1.18)

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income (Loss)

Three months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Net income (loss)	$ 688	$ (2,886)
Other comprehensive income (loss):		
Unrealized gain (loss) on available for sale securities, net of tax	(205)	515
Reclassification adjustment, net of tax	(167)	
Other comprehensive income (loss), net of tax	(372)	515
Total comprehensive income (loss)	$ 316	$ (2,371)

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income

Nine months ended September 30, 2012 and 2011

(in thousands, except per share data)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Net income (loss)	$ 1,857	$ (2,828)
Other comprehensive income (loss):		
Unrealized gain on available for sale securities, net of tax	122	1,481
Reclassification adjustment, net of tax	(1,285)	(27)
Other comprehensive income (loss)	(1,163)	1,454
Total comprehensive income (loss)	$ 694	$ (1,374)

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Nine months ended September 30, 2012 and 2011

(in thousands)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Cash Flows from Operating Activities		
Net income (loss)	$ 1,857	$ (2,828)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	836	896
Origination of loans held for sale	(5,279)	(6,277)
Proceeds from sale of loans held for sale	5,696	6,642
Gains on sale of loans held for sale	(143)	(94)
Provision for loan losses	3,455	9,395
Provision for other real estate owned	595	1,103
Gains on sale of securities available for sale, net	(1,285)	(41)
Net gains on sale of other real estate owned	(297)	(28)
Accretion of discounts and amortization of premiums on securities, net	586	339
Changes in assets and liabilities:		
Decrease in interest receivable	39	7
(Increase) decrease in other assets	2,868	(1,233)
Increase (decrease) in other liabilities	152	(231)
Net cash provided by operating activities	$ 9,080	$ 7,650
Cash Flows from Investing Activities		
Proceeds from sales of securities available for sale	$ 26,158	$ 2,557
Proceeds from maturities, calls, and principal payments of securities available for sale	19,274	11,075
Purchase of securities available for sale	(50,100)	(36,768)
Proceeds from redemption of restricted securities	832	264
Purchase of restricted securities	(30)	
Decrease in federal funds sold		7,500
Purchase of premises and equipment	(419)	(251)
Proceeds from sale of other real estate owned	5,041	784
Net decrease in loans	5,058	15,520
Net cash provided by investing activities	$ 5,814	$ 681
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$ 11,066	$ 14,575
Net decrease in time deposits	(23,280)	(20,053)
Proceeds from other borrowings		33,001
Principal payments on other borrowings	(13,018)	(28,017)
Net proceeds from issuance of common stock	7,601	

Cash dividends paid on common stock				(541)
Cash dividends paid on preferred stock		(568)		(568)
Net cash used in financing activities	$	(18,199)	$	(1,603)
Increase (decrease) in cash and cash equivalents	$	(3,305)	$	6,728
Cash and Cash Equivalents				
Beginning	$	29,524	$	15,997
Ending	$	26,219	$	22,725

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Nine months ended September 30, 2012 and 2011

(in thousands)

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 3,299	$ 4,422
Income taxes	$ 940	$
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gain (loss) on securities available for sale	$ (1,193)	$ 2,202
Transfer from loans to other real estate owned	$ 4,287	$ 3,373
Loan originated from sale of other real estate owned	$	$ 640
Issuance of common stock, dividend reinvestment plan	$	$ 71

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

Nine months ended September 30, 2012 and 2011

(in thousands, except share and per share data)

(unaudited)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2010	$ 14,127	$ 3,686	$ 1,582	$ 28,969	$ 134	$ 48,498
Net loss				(2,828)		(2,828)
Other comprehensive income					1,454	1,454
Cash dividends on common stock ($0.20 per share)				(612)		(612)
Issuance of 6,748 shares common stock, dividend reinvestment plan		9	62			71
Cash dividends on preferred stock				(568)		(568)
Accretion on preferred stock discount	102			(102)		
Balance, September 30, 2011	$ 14,229	$ 3,695	$ 1,644	$ 24,859	$ 1,588	$ 46,015

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2011	$ 14,263	$ 3,695	$ 1,644	$ 16,503	$ 991	$ 37,096
Net income				1,857		1,857
Other comprehensive loss					(1,163)	(1,163)
Issuance of common stock, net of offering costs		2,432	5,169			7,601
Cash dividends on preferred stock				(568)		(568)
Accretion on preferred stock discount	109			(109)		
Balance, September 30, 2012	$ 14,372	$ 6,127	$ 6,813	$ 17,683	$ (172)	$ 44,823

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 September 30, 2012 and December 31, 2011, the results of operations and comprehensive income for the three and nine months ended September 30, 2012 and 2011 and the cash flows and changes in shareholders equity for the nine months ended September 30, 2012 and 2011. 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, 2011. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

Recent Accounting Pronouncements

In April 2011, the FASB issued ASU 2011-03, Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements. The amendments in this ASU removed from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU were effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments were effective for interim and annual periods beginning after December 15, 2011 with prospective application. The Company has included the required disclosures in its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in shareholders equity. The amendments require that all non-owner changes in shareholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments were effective for fiscal years and interim periods within those years beginning after December 15, 2011. The Company has included the required disclosures in its consolidated financial statements.

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FIRST NATIONAL CORPORATION

Notes to Consolidated Financial Statements

(unaudited)

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The amendments are being made to allow the Board time to re-deliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011.

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 September 30, 2012 and December 31, 2011 were as follows:

	(in thousands) September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 78,251	$ 1,559	$ (230)	$ 79,580
Obligations of states and political subdivisions	15,585	753	(83)	16,255
Corporate equity securities	1	3		4
	$ 93,837	$ 2,315	$ (313)	$ 95,839

	(in thousands) December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value

U.S. agency and mortgage-backed securities	$ 76,549	$	2,343	$	(16)	$ 78,876
Obligations of states and political subdivisions	11,895		781			12,676
Corporate equity securities	26		87			113
	$ 88,470	$	3,211	$	(16)	$ 91,665

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Notes to Consolidated Financial Statements

(unaudited)

At September 30, 2012 and December 31, 2011, investments in an unrealized loss position that were temporarily impaired were as follows:

	(in thousands) September 30, 2012					
	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	$ 23,118	$ (230)	$	$	$ 23,118	$ (230)
Obligations of states and political subdivisions	4,817	(83)			4,817	(83)
	$ 27,935	$ (313)	$	$	$ 27,935	$ (313)

	(in thousands) December 31, 2011					
	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	$ 3,955	$ (16)	$	$	$ 3,955	$ (16)

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 September 30, 2012, there were thirteen U.S. agency and mortgage-backed securities and ten 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 3.8 years at September 30, 2012.

The Company s investment in Federal Home Loan Bank (FHLB) stock totaled $1.1 million at September 30, 2012. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. 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 September 30, 2012, 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.

The composition of restricted securities at September 30, 2012 and December 31, 2011 was as follows:

	(in thousands)	
	September 30, 2012	December 31, 2011
Federal Home Loan Bank stock	$ 1,078	$ 1,910
Federal Reserve Bank stock	845	815
Community Bankers Bank stock	50	50
	$ 1,973	$ 2,775

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Notes to Consolidated Financial Statements

(unaudited)

Note 3. Loans

Loans at September 30, 2012 and December 31, 2011 are summarized as follows:

	(in thousands)	
	September 30, 2012	December 31, 2011
Real estate loans:		
Construction and land development	$ 44,725	$ 48,363
Secured by 1-4 family residential	128,354	122,339
Other real estate loans	175,122	181,141
Commercial and industrial loans	24,216	29,446
Consumer and other loans	8,335	11,151
Total loans	$ 380,752	$ 392,440
Allowance for loan losses	14,049	12,937
Loans, net	$ 366,703	$ 379,503

Consumer loans included $109 thousand and $325 thousand of demand deposit overdrafts at September 30, 2012 and December 31, 2011, respectively.

The Company 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 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 more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy, or other changes in circumstances.

Notes to Consolidated Financial Statements

(unaudited)

The following table provides a summary of loan classes and an aging of past due loans as of September 30, 2012 and December 31, 2011:

September 30, 2012 (in thousands)	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	$ 325	$ 528	$ 2,472	$ 3,325	$ 41,400	$ 44,725	$ 621	$ 1,851
1-4 family residential	1,272	207	693	2,172	126,182	128,354	1,389	300
Other real estate loans	2,881	1,637	186	4,704	170,418	175,122	6,961	
Commercial and industrial	432	220	25	677	23,539	24,216	15	25
Consumer and other loans	56		25	81	8,254	8,335	12	
Total	$ 4,966	$ 2,592	$ 3,401	$ 10,959	$ 369,793	$ 380,752	$ 8,998	$ 2,176

December 31, 2011 (in thousands)	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	$ 2,267	$ 1,029	$ 235	$ 3,531	$ 44,832	$ 48,363	$ 235	$
1-4 family residential	4,179	471	688	5,338	117,001	122,339	3,043	98
Other real estate loans	3,863	562	722	5,147	175,994	181,141	8,367	361
Commercial and industrial	950	93	5	1,048	28,398	29,446	163	
Consumer and other loans	94	19	14	127	11,024	11,151	33	
Total	$ 11,353	$ 2,174	$ 1,664	$ 15,191	$ 377,249	$ 392,440	$ 11,841	$ 459

Credit Quality Indicators

As part of the on-going 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 delinquency 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:

Special Mention Loans classified as special mention have a potential weakness that deserve 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 and/or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation in full 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 weakness 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.

The following tables provide an analysis of the credit risk profile of each loan class as of September 30, 2012 and December 31, 2011:

	September 30, 2012 *(in thousands)*				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 23,062	$ 4,206	$ 17,457	$	$ 44,725
Secured by 1-4 family residential	114,120	4,518	9,716		128,354
Other real estate loans	138,949	12,085	24,088		175,122
Commercial and industrial	19,766	836	3,614		24,216
Consumer and other loans	8,261	74			8,335
Total	$ 304,158	$ 21,719	$ 54,875	$	$ 380,752

	December 31, 2011 *(in thousands)*				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 23,172	$ 7,504	$ 17,452	$ 235	$ 48,363
Secured by 1-4 family residential	108,240	5,645	8,266	188	122,339
Other real estate loans	138,255	17,123	22,348	3,415	181,141
Commercial and industrial	23,451	949	4,976	70	29,446
Consumer and other loans	11,058	79		14	11,151
Total	$ 304,176	$ 31,300	$ 53,042	$ 3,922	$ 392,440

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the nine months ended September 30, 2012 and 2011 and for the year ended December 31, 2011 were as follows:

		(in thousands)	
	September 30, 2012	December 31, 2011	September 30, 2011
Balance at beginning of year	$ 12,937	$ 16,036	$ 16,036
Provision charged to operating expense	3,455	12,380	9,395
Loan recoveries	240	310	208
Loan charge-offs	(2,583)	(15,789)	(7,137)
Balance at end of period	$ 14,049	$ 12,937	$ 18,502

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The following tables present, as of September 30, 2012 and December 31, 2011, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	September 30, 2012 *(in thousands)*					
	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, 2011	$ 2,843	$ 3,766	$ 5,192	$ 963	$ 173	$ 12,937
Charge-offs	(369)	(761)	(1,042)	(261)	(150)	(2,583)
Recoveries	1	2	58	24	155	240
Provision for loan losses	1,059	992	1,531	(75)	(52)	3,455
Ending Balance, September 30, 2012	$ 3,534	$ 3,999	$ 5,739	$ 651	$ 126	$ 14,049
Ending Balance:						
Individually evaluated for impairment	1,728	709	762	40		3,239
Collectively evaluated for impairment	1,806	3,290	4,977	611	126	10,810
Loans:						
Ending Balance	44,725	128,354	175,122	24,216	8,335	380,752
Individually evaluated for impairment	6,353	4,758	8,597	164		19,872
Collectively evaluated for impairment	38,372	123,596	166,525	24,052	8,335	360,880

	December 31, 2011 *(in thousands)*					
	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, 2010	$ 4,050	$ 1,681	$ 9,187	$ 858	$ 260	$ 16,036
Charge-offs	(2,983)	(4,639)	(7,551)	(348)	(268)	(15,789)
Recoveries	50	6		3	251	310
Provision for loan losses	1,726	6,718	3,556	450	(70)	12,380
Ending Balance, December 31, 2011	$ 2,843	$ 3,766	$ 5,192	$ 963	$ 173	$ 12,937
Ending Balance:						
Individually evaluated for impairment	930	848	351	309		2,438
Collectively evaluated for impairment	1,913	2,918	4,841	654	173	10,499
Loans:						
Ending Balance	48,363	122,339	181,141	29,446	11,151	392,440

Individually evaluated for impairment	7,640	6,860	10,940	480		25,920
Collectively evaluated for impairment	40,723	115,479	170,201	28,966	11,151	366,520

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Impaired loans and the related allowance at September 30, 2012 and December 31, 2011, were as follows:

	September 30, 2012 *(in thousands)*						
	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	$ 6,683	$ 596	$ 5,758	$ 6,353	$ 1,728	$ 5,516	$ 238
Secured by 1-4 family	5,801	1,955	2,803	4,758	709	5,244	143
Other real estate loans	12,673	5,569	3,027	8,597	762	10,155	88
Commercial and industrial	165		164	164	40	386	6
Consumer and other loans							
Total	$ 25,322	$ 8,120	$ 11,752	$ 19,872	$ 3,239	$ 21,302	$ 475

	December 31, 2011 *(in thousands)*						
	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	$ 8,106	$ 3,531	$ 4,109	$ 7,640	$ 930	$ 7,077	$ 367
Secured by 1-4 family	8,566	3,495	3,365	6,860	848	6,519	301
Other real estate loans	15,165	8,135	2,805	10,940	351	23,918	396
Commercial and industrial	480		480	480	309	660	27
Consumer and other loans							
Total	$ 32,317	$ 15,161	$ 10,758	$ 25,920	$ 2,438	$ 38,174	$ 1,091

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

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As of September 30, 2012, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled $5.4 million. At September 30, 2012, $1.6 million of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were $11.4 million in TDRs at December 31, 2011. The following tables provide further information regarding loans modified under TDRs during the three and nine month periods ended September 30, 2012 and 2011:

	For the three months ended September 30, 2012 *(dollars in thousands)*			For the three months ended September 30, 2011 *(dollars in thousands)*		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Real estate loans:						
Construction		$	$	1	$ 701	$ 357
Secured by 1-4 family	1	183	183			
Other real estate loans						
Commercial and industrial						
Consumer and other loans						
Total	1	$ 183	$ 183	1	$ 701	$ 357

	For the nine months ended September 30, 2012 *(dollars in thousands)*			For the nine months ended September 30, 2011 *(dollars in thousands)*		
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Real estate loans:						
Construction		$	$	1	$ 701	$ 357
Secured by 1-4 family	1	183	183	2	575	575
Other real estate loans	1	2,426	2,426	12	11,724	11,750
Commercial and industrial						
Consumer and other loans						
Total	2	$ 2,609	$ 2,609	15	$ 13,000	$ 12,682

For the three and nine months ended September 30, 2012 and 2011, 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 during the twelve month period subsequent to the modification.

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Note 5. Other Real Estate Owned

At September 30, 2012 and December 31, 2011, OREO totaled $5.3 million and $6.4 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties associated with commercial relationships, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows:

	(in thousands)	
	For the nine months ended September 30, 2012	For the year ended December 31, 2011
Balance at the beginning of year, gross	$ 9,166	$ 7,302
Transfers from loans	4,287	8,117
Charge-offs	(1,539)	(2,022)
Sales proceeds	(5,041)	(3,321)
Gain (loss) on disposition	297	(910)
Balance at the end of period, gross	7,170	9,166
Less: allowance for losses	(1,847)	(2,792)
Balance at the end of period, net	$ 5,323	$ 6,374

Changes in the allowance for OREO losses are as follows:

	(in thousands)		
	For the nine months ended		For the year ended
	September 30, 2012	September 30, 2011	December 31, 2011
Balance at beginning of year	$ 2,792	$ 3,341	$ 3,341
Provision for losses	595	1,103	1,558
Charge-offs, net	(1,539)	(445)	(2,107)
Balance at end of period	$ 1,847	$ 3,999	$ 2,792

Net expenses applicable to OREO, other than the provision for losses, were $450 thousand and $325 thousand for the nine months ended September 30, 2012 and 2011, respectively.

Note 6. Other Borrowings

The Bank had unused lines of credit totaling $98.8 million available with non-affiliated banks at September 30, 2012. 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 September 30, 2012, 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 at September 30, 2012. The Bank had collateral pledged on these borrowings and letter of credit, including real estate loans totaling $101.6 million and FHLB stock with a book value of $1.1 million.

At September 30, 2012, the Bank had an $82 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%.

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Note 7. Capital Requirements

A comparison of the capital of the Company and the Bank at September 30, 2012 and December 31, 2011 with the minimum regulatory guidelines were as follows:

	(dollars in thousands)	Minimum To Be Well Capitalized Under
	Minimum Capital	