

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 13, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2008

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**54-1232965**  
(I.R.S. Employer  
Identification No.)

**112 West King Street, Strasburg, Virginia**  
(Address of principal executive offices)

**22657**  
(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  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

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

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

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

|   | (unaudited)       |                      |
|---|-------------------|----------------------|
|   | June 30,<br>2008  | December 31,<br>2007 |
| <b>Assets</b>   |                   |                      |
| Cash and due from banks   | \$ 8,783          | \$ 10,680            |
| Interest-bearing deposits in banks  | 2,174             | 2,229                |
| Securities available for sale, at fair value  | 56,286            | 57,503               |
| Loans held for sale   | 457               | 270                  |
| Loans, net of allowance for loan losses, 2008, \$4,480, 2007, \$4,207   | 445,359           | 445,380              |
| Premises and equipment, net   | 21,205            | 19,405               |
| Interest receivable   | 1,834             | 2,227                |
| Other assets  | 4,061             | 3,871                |
| <b>Total assets</b>   | <b>\$ 540,159</b> | <b>\$ 541,565</b>    |
| <b>Liabilities and Shareholders Equity</b>  |                   |                      |
| <b>Liabilities</b>  |                   |                      |
| Deposits:   |                   |                      |
| Noninterest-bearing demand deposits   | \$ 89,040         | \$ 78,474            |
| Savings and interest-bearing demand deposits  | 153,742           | 177,676              |
| Time deposits   | 182,886           | 188,992              |
| <b>Total deposits</b>   | <b>\$ 425,668</b> | <b>\$ 445,142</b>    |
| Federal funds purchased   | 7,753             | 3,409                |
| Other borrowings  | 56,499            | 40,564               |
| Company obligated mandatorily redeemable capital securities   | 9,279             | 12,372               |
| Accrued expenses and other liabilities  | 1,524             | 2,219                |
| Commitments and contingencies   |                   |                      |
| <b>Total liabilities</b>  | <b>\$ 500,723</b> | <b>\$ 503,706</b>    |
| <b>Shareholders Equity</b>  |                   |                      |
| Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2,922,860 shares | \$ 3,653          | \$ 3,653             |
| Surplus   | 1,435             | 1,453                |

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|  |            |            |
|--|------------|------------|
| Retained earnings                          | 35,311     | 33,311     |
| Unearned ESOP shares                       | (324)      | (379)      |
| Accumulated other comprehensive loss, net  | (639)      | (179)      |
| Total shareholders' equity                 | \$ 39,436  | \$ 37,859  |
| Total liabilities and shareholders' equity | \$ 540,159 | \$ 541,565 |

*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2008 and 2007

*(in thousands, except per share data)*

|   | (unaudited)<br>June 30,<br>2008 | (unaudited)<br>June 30,<br>2007 |
|---|---------------------------------|---------------------------------|
| <b>Interest and Dividend Income</b>                                     |                                 |                                 |
| Interest and fees on loans  | \$ 6,882                        | \$ 8,065                        |
| Interest on federal funds sold  | 2                               | 10                              |
| Interest on deposits in banks   | 12                              | 25                              |
| Interest and dividends on securities available for sale:                |                                 |                                 |
| Taxable interest  | 489                             | 535                             |
| Tax-exempt interest   | 131                             | 116                             |
| Dividends   | 48                              | 48                              |
| <b>Total interest and dividend income</b>                               | <b>\$ 7,564</b>                 | <b>\$ 8,799</b>                 |
| <b>Interest Expense</b>   |                                 |                                 |
| Interest on deposits  | \$ 2,339                        | \$ 3,551                        |
| Interest on federal funds purchased                                     | 49                              | 41                              |
| Interest on company obligated mandatorily redeemable capital securities | 142                             | 238                             |
| Interest on other borrowings  | 454                             | 538                             |
| <b>Total interest expense</b>   | <b>\$ 2,984</b>                 | <b>\$ 4,368</b>                 |
| Net interest income   | \$ 4,580                        | \$ 4,431                        |
| Provision for loan losses   | 84                              | 67                              |
| Net interest income after provision for loan losses                     | \$ 4,496                        | \$ 4,364                        |
| <b>Noninterest Income</b>   |                                 |                                 |
| Service charges on deposit accounts                                     | \$ 708                          | \$ 772                          |
| Fees for other customer services  | 417                             | 319                             |
| Trust and investment advisory fees                                      | 356                             | 282                             |
| Gains on sale of loans  | 32                              | 52                              |
| Gains on sale of securities available for sale                          | 2                               |                                 |
| Gains on sale of premises and equipment                                 |                                 | 1                               |
| Other operating income  | 20                              | 14                              |
| <b>Total noninterest income</b>   | <b>\$ 1,535</b>                 | <b>\$ 1,440</b>                 |

**Noninterest Expense**

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|   |                 |                 |
|---|-----------------|-----------------|
| Salaries and employee benefits                      | \$ 2,218        | \$ 2,207        |
| Occupancy   | 274             | 228             |
| Equipment   | 344             | 310             |
| Marketing   | 106             | 162             |
| Stationery and supplies                             | 82              | 135             |
| Legal and professional fees                         | 147             | 174             |
| ATM and check card fees                             | 156             | 134             |
| Other operating expense                             | 650             | 561             |
| <b>Total noninterest expense</b>                    | <b>\$ 3,977</b> | <b>\$ 3,911</b> |
| Income before income taxes                          | \$ 2,054        | \$ 1,893        |
| Provision for income taxes                          | 654             | 613             |
| <b>Net income</b>                                   | <b>\$ 1,400</b> | <b>\$ 1,280</b> |
| <b>Earnings per common share, basic and diluted</b> | <b>\$ 0.48</b>  | <b>\$ 0.44</b>  |

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2008 and 2007

*(in thousands, except per share data)*

|   | (unaudited)<br>June 30,<br>2008 | (unaudited)<br>June 30,<br>2007 |
|---|---------------------------------|---------------------------------|
| <b>Interest and Dividend Income</b>                                     |                                 |                                 |
| Interest and fees on loans  | \$ 14,600                       | \$ 16,018                       |
| Interest on federal funds sold  | 8                               | 24                              |
| Interest on deposits in banks   | 30                              | 50                              |
| Interest and dividends on securities available for sale:                |                                 |                                 |
| Taxable interest  | 1,004                           | 1,070                           |
| Tax-exempt interest   | 264                             | 231                             |
| Dividends   | 98                              | 95                              |
| <b>Total interest and dividend income</b>                               | <b>\$ 16,004</b>                | <b>\$ 17,488</b>                |
| <b>Interest Expense</b>   |                                 |                                 |
| Interest on deposits  | \$ 5,372                        | \$ 7,093                        |
| Interest on federal funds purchased                                     | 68                              | 80                              |
| Interest on company obligated mandatorily redeemable capital securities | 365                             | 474                             |
| Interest on other borrowings  | 967                             | 1,088                           |
| <b>Total interest expense</b>   | <b>\$ 6,772</b>                 | <b>\$ 8,735</b>                 |
| Net interest income   | \$ 9,232                        | \$ 8,753                        |
| Provision for loan losses   | 354                             | 67                              |
| Net interest income after provision for loan losses                     | \$ 8,878                        | \$ 8,686                        |
| <b>Noninterest Income</b>   |                                 |                                 |
| Service charges on deposit accounts                                     | \$ 1,406                        | \$ 1,391                        |
| Fees for other customer services  | 754                             | 618                             |
| Trust and investment advisory fees                                      | 686                             | 559                             |
| Gains on sale of loans  | 69                              | 125                             |
| Gains on sale of securities available for sale                          | 2                               |                                 |
| Gains on sale of premises and equipment                                 |                                 | 1                               |
| Other operating income  | 118                             | 36                              |
| <b>Total noninterest income</b>   | <b>\$ 3,035</b>                 | <b>\$ 2,730</b>                 |

**Noninterest Expense**



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|   |                 |                 |
|---|-----------------|-----------------|
| Salaries and employee benefits                      | \$ 4,321        | \$ 4,073        |
| Occupancy   | 524             | 474             |
| Equipment   | 691             | 628             |
| Marketing   | 212             | 290             |
| Stationery and supplies                             | 193             | 242             |
| Legal and professional fees                         | 320             | 342             |
| ATM and check card fees                             | 303             | 252             |
| Other operating expense                             | 1,230           | 1,149           |
| <b>Total noninterest expense</b>                    | <b>\$ 7,794</b> | <b>\$ 7,450</b> |
| Income before income taxes                          | \$ 4,119        | \$ 3,966        |
| Provision for income taxes                          | 1,304           | 1,283           |
| <b>Net income</b>                                   | <b>\$ 2,815</b> | <b>\$ 2,683</b> |
| <b>Earnings per common share, basic and diluted</b> | <b>\$ 0.97</b>  | <b>\$ 0.92</b>  |

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2008 and 2007

*(in thousands)*

|  | (unaudited)<br>June 30,<br>2008 | (unaudited)<br>June 30,<br>2007 |
|--|---------------------------------|---------------------------------|
| <b>Cash Flows from Operating Activities</b>  |                                 |                                 |
| Net income   | \$ 2,815                        | \$ 2,683                        |
| Adjustments to reconcile net income to cash and cash equivalents provided by operating activities: |                                 |                                 |
| Depreciation and amortization  | 576                             | 553                             |
| Origination of loans held for sale   | (7,046)                         | (10,295)                        |
| Proceeds from sale of loans available for sale   | 6,928                           | 10,127                          |
| Gains on sale of loans   | (69)                            | (125)                           |
| Provision for loan losses  | 354                             | 67                              |
| Gains on sale of securities available for sale   | (2)                             |                                 |
| Gains on sale of premises and equipment  |                                 | (1)                             |
| Accretion of security discounts  | (26)                            | (17)                            |
| Amortization of security premiums  | 43                              | 50                              |
| Shares acquired by leveraged ESOP  | 55                              | 51                              |
| Changes in assets and liabilities:   |                                 |                                 |
| (Increase) decrease in interest receivable   | 393                             | (26)                            |
| Increase in other assets   | (57)                            | (133)                           |
| Increase (decrease) in accrued expenses and other liabilities                                      | (590)                           | 429                             |
| Net cash provided by operating activities  | \$ 3,374                        | \$ 3,363                        |
| <b>Cash Flows from Investing Activities</b>  |                                 |                                 |
| Proceeds from sales of securities available for sale   | \$ 1,012                        | \$ 1,013                        |
| Proceeds from maturities, calls, and principal payments of securities available for sale           | 4,652                           | 5,068                           |
| Purchase of securities available for sale  | (5,160)                         | (7,100)                         |
| Decrease in federal funds sold   |                                 | 8,430                           |
| Proceeds from sale of premises and equipment   |                                 | 1                               |
| Purchase of premises and equipment   | (2,376)                         | (1,596)                         |
| Net increase in loans  | (333)                           | (7,543)                         |
| Net cash used in investing activities  | \$ (2,205)                      | \$ (1,727)                      |
| <b>Cash Flows from Financing Activities</b>  |                                 |                                 |
| Net increase (decrease) in demand deposits and savings accounts                                    | \$ (13,368)                     | \$ 10,608                       |
| Net decrease in time deposits  | (6,106)                         | (11,421)                        |
| Proceeds from other borrowings   | 44,500                          | 83,500                          |
| Principal payments on other borrowings   | (28,565)                        | (88,560)                        |
| Principal payments on company obligated mandatorily redeemable capital securities                  | (3,093)                         |                                 |

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|  |                   |                   |
|--|-------------------|-------------------|
| Cash dividends paid                              | (815)             | (755)             |
| Increase in federal funds purchased              | 4,344             | 5,260             |
| Shares issued to leveraged ESOP                  | (18)              | (1)               |
| <b>Net cash used in financing activities</b>     | <b>\$ (3,121)</b> | <b>\$ (1,369)</b> |
| Increase (decrease) in cash and cash equivalents | \$ (1,952)        | \$ 267            |
| <b>Cash and Cash Equivalents</b>                 |                   |                   |
| Beginning  | \$ 12,909         | \$ 12,127         |
| Ending   | \$ 10,957         | \$ 12,394         |

*See Notes to Consolidated Financial Statements*

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

(Continued)

Six months ended June 30, 2008 and 2007

*(in thousands)*

|   | (unaudited)<br>June 30,<br>2008 | (unaudited)<br>June 30,<br>2007 |
|---|---------------------------------|---------------------------------|
| <b>Supplemental Disclosures of Cash Flow Information</b>        |                                 |                                 |
| Cash payments for:  |                                 |                                 |
| Interest  | \$ 6,959                        | \$ 8,724                        |
| Income taxes  | \$ 1,609                        | \$ 833                          |
| <b>Supplemental Disclosures of Noncash Investing Activities</b> |                                 |                                 |
| Unrealized loss on securities available for sale                | \$ (698)                        | \$ (762)                        |
| Transfer from loans to other real estate                        | \$                              | \$ 377                          |

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2008 and 2007

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

|   | Common<br>Stock | Surplus  | Retained<br>Earnings | Unearned<br>ESOP<br>Shares | Accumulated<br>Other<br>Comprehensive<br>Loss | Comprehensive<br>Income | Total     |
|---|-----------------|----------|----------------------|----------------------------|---|-------------------------|-----------|
| <b>Balance, December 31, 2006</b>   | \$ 3,653        | \$ 1,465 | \$ 29,104            | \$ (546)                   | \$ (1,121)                                    |                         | \$ 32,555 |
| Comprehensive income:   |                 |          |                      |                            |   |                         |           |
| Net income  |                 |          | 2,683                |                            |   | \$ 2,683                | 2,683     |
| Other comprehensive loss, net of tax, unrealized holding losses arising during the period (net of tax, \$259) |                 |          |                      |                            | (503)   | (503)                   | (503)     |
| Total comprehensive income  |                 |          |                      |                            |   | \$ 2,180                |           |
| Shares acquired by leveraged ESOP   |                 | (1)      |                      | 51                         |   |                         | 50        |
| Cash dividends (\$0.26 per share)   |                 |          | (755)                |                            |   |                         | (755)     |
| <b>Balance, June 30, 2007</b>   | \$ 3,653        | \$ 1,464 | \$ 31,032            | \$ (495)                   | \$ (1,624)                                    |                         | \$ 34,030 |

|   | Common<br>Stock | Surplus  | Retained<br>Earnings | Unearned<br>ESOP<br>Shares | Accumulated<br>Other<br>Comprehensive<br>Loss | Comprehensive<br>Income | Total     |
|---|-----------------|----------|----------------------|----------------------------|---|-------------------------|-----------|
| <b>Balance, December 31, 2007</b>                                       | \$ 3,653        | \$ 1,453 | \$ 33,311            | \$ (379)                   | \$ (179)                                      |                         | \$ 37,859 |
| Comprehensive income:   |                 |          |                      |                            |   |                         |           |
| Net income  |                 |          | 2,815                |                            |   | \$ 2,815                | 2,815     |
| Other comprehensive loss, net of tax:                                   |                 |          |                      |                            |   |                         |           |
| Unrealized holding losses arising during the period (net of tax, \$237) |                 |          |                      |                            |   | (459)                   | (459)     |
| Reclassification adjustment (net of tax, \$1)                           |                 |          |                      |                            |   | (1)                     | (1)       |
| Other comprehensive loss (net of tax, \$238)                            |                 |          |                      |                            | (460)   | (460)                   | (460)     |

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|                                   |          |          |           |          |    |       |           |
|-----------------------------------|----------|----------|-----------|----------|----|-------|-----------|
| Total comprehensive income        |          |          |           |          |    | \$    | 2,355     |
| Shares acquired by leveraged ESOP | (18)     |          | 55        |          |    |       | 37        |
| Cash dividends (\$0.28 per share) |          | (815)    |           |          |    |       | (815)     |
| <b>Balance, June 30, 2008</b>     | \$ 3,653 | \$ 1,435 | \$ 35,311 | \$ (324) | \$ | (639) | \$ 39,436 |

*See Notes to Consolidated Financial Statements*

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

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications consisting of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2008 and December 31, 2007, the results of operations for the three and six months ended June 30, 2008 and 2007 and cash flows and changes in shareholders' equity for the six months ended June 30, 2008 and 2007. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2007. Operating results for the three and six month periods ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and restricted securities. Restricted securities include required equity investments in certain correspondent banks. All of the Company's securities were classified as available for sale at June 30, 2008 and December 31, 2007. Amortized costs and fair values were as follows:

|  | <i>(in thousands)</i> |                   |                   |                  |
|--|-----------------------|-------------------|-------------------|------------------|
|  | <b>June 30, 2008</b>  |                   |                   |                  |
|  | <b>Amortized</b>      | <b>Gross</b>      | <b>Gross</b>      | <b>Fair</b>      |
|  | <b>Cost</b>           | <b>Unrealized</b> | <b>Unrealized</b> | <b>Value</b>     |
|  |                       | <b>Gains</b>      | <b>(Losses)</b>   |                  |
| U.S. agency and mortgage-backed securities       | \$ 38,325             | \$ 113            | \$ (369)          | \$ 38,069        |
| Obligations of states and political subdivisions | 14,192                | 114               | (250)             | 14,056           |
| Corporate equity securities                      | 13                    | 116               |                   | 129              |
| Restricted securities                            | 4,032                 |                   |                   | 4,032            |
|  | <b>\$ 56,562</b>      | <b>\$ 343</b>     | <b>\$ (619)</b>   | <b>\$ 56,286</b> |

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

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



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

At June 30, 2008 and December 31, 2007, investments in an unrealized loss position that were temporarily impaired were as follows:

|  | <i>(in thousands)</i> |                   |                   |                   |            |                   |
|--|-----------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Less than 12 months   |                   | 12 months or more |                   | Total      |                   |
|  | Fair Value            | Unrealized (Loss) | Fair Value        | Unrealized (Loss) | Fair Value | Unrealized (Loss) |
| U.S. agency and mortgage- backed securities      | \$ 16,059             | \$ (275)          | \$ 1,456          | \$ (94)           | \$ 17,515  | \$ (369)          |
| Obligations of states and political subdivisions | 6,743                 | (250)             |                   |                   | 6,743      | (250)             |
|  | \$ 22,802             | \$ (525)          | \$ 1,456          | \$ (94)           | \$ 24,258  | \$ (619)          |

|  | <i>(in thousands)</i> |                   |                   |                   |            |                   |
|--|-----------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | 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      | \$ 12,606             | \$ (168)          | \$ 12,206         | \$ (168)          | \$ 12,206  | \$ (168)          |
| Obligations of states and political subdivisions | 1,575                 | (21)              | 1,544             | (15)              | 3,119      | (36)              |
|  | \$ 1,575              | \$ (21)           | \$ 13,750         | \$ (183)          | \$ 15,325  | \$ (204)          |

The tables above provide information about securities that have been in an unrealized loss position for less than twelve consecutive months and securities that have been in an unrealized loss position for twelve consecutive months or more. Securities with unrealized losses are considered temporarily impaired and are primarily a result of interest rate factors. Seven obligations of states and political subdivisions experienced rating downgrades during the second quarter of 2008. This was the direct result of downgrades of the insurers of these bonds. Although ratings were lowered for these securities, they are all still considered investment grade. The Company has the ability and intent to hold these issues until maturity. At June 30, 2008, there were fifteen U.S. agency and mortgage-backed securities and eighteen obligations of state and political subdivisions in an unrealized loss position. Ninety-two percent of the Company's investment portfolio had AAA credit ratings with a weighted-average repricing term of 4.4 years at June 30, 2008.

**Note 3. Loans**

Loans at June 30, 2008 are summarized as follows:

|                                | <i>(in thousands)</i> |                   |
|--------------------------------|-----------------------|-------------------|
|                                | June 30, 2008         | December 31, 2007 |
| Mortgage loans on real estate: |                       |                   |
| Construction                   | \$ 71,574             | \$ 73,478         |

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|   |                   |                   |
|---|-------------------|-------------------|
| Secured by farm land  | 1,738             | 1,789             |
| Secured by 1-4 family residential                                     | 110,989           | 106,378           |
| Other real estate loans   | 192,228           | 192,616           |
| Loans to farmers (except those secured by real estate)                | 2,487             | 2,144             |
| Commercial and industrial loans (except those secured by real estate) | 53,602            | 53,028            |
| Consumer loans  | 16,188            | 18,363            |
| Deposit overdrafts  | 307               | 415               |
| All other loans   | 726               | 1,376             |
| <b>Total loans</b>  | <b>\$ 449,839</b> | <b>\$ 449,587</b> |
| Allowance for loan losses   | 4,480             | 4,207             |
| <b>Loans, net</b>   | <b>\$ 445,359</b> | <b>\$ 445,380</b> |

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

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$376.5 million, or 83.7% of total loans and \$374.3 million, or 83.2% of total loans, at June 30, 2008 and December 31, 2007, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be affected by local economic conditions. Construction loans totaled \$71.6 million and \$73.5 million, or 15.9% and 16.3% of total loans at June 30, 2008 and December 31, 2007, respectively.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$44.9 million at June 30, 2008, representing 114.0% of total shareholders' equity and 10.0% of total loans. At December 31, 2007, this concentration totaled \$43.4 million representing 114.7% of total shareholders' equity and 9.6% of total loans. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this concentration of credit risk during the six month period ended June 30, 2008 and the year ended December 31, 2007.

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the six months ended June 30, 2008 and 2007 and for the year ended December 31, 2007 were as follows:

|  | <i>(in thousands)</i>    |                              |                          |
|--|--------------------------|------------------------------|--------------------------|
|  | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> | <b>June 30,<br/>2007</b> |
| Balance at beginning of year           | \$ 4,207                 | \$ 3,978                     | \$ 3,978                 |
| Provision charged to operating expense | 354                      | 398                          | 67                       |
| Loan recoveries                        | 143                      | 213                          | 105                      |
| Loan charge-offs                       | (224)                    | (382)                        | (153)                    |
| <b>Balance at end of period</b>        | <b>\$ 4,480</b>          | <b>\$ 4,207</b>              | <b>\$ 3,997</b>          |

Impaired loans of \$7.1 million at June 30, 2008 and \$3.3 million at December 31, 2007 have been recognized in conformity with SFAS No. 114. The related allowance for loan losses provided for these loans totaled \$118 thousand and \$12 thousand at June 30, 2008 and December 31, 2007, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2008 and the year ended December 31, 2007 was \$4.6 million and \$952 thousand, respectively.

**Note 5. Other Borrowings**

The Bank had unused lines of credit totaling \$60.3 million available with non-affiliated banks at June 30, 2008. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets.

At June 30, 2008, the Bank had borrowings from the FHLB system totaling \$56.0 million which mature through March 17, 2011. The interest rate on these notes payable ranged from 2.44% to 5.26% and the weighted average rate was 3.20%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$50.3 million at June 30, 2008 and FHLB stock and other investment securities with a book value of \$30.0 million at June 30, 2008.

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At June 30, 2008, the Bank had a \$175 thousand note payable, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%. The Company also had an unsecured note payable of \$324 thousand, which requires monthly payments of \$11 thousand and matures September 12, 2011. The fixed interest rate on this loan is 7.35%.

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

A comparison of the capital of the Company and the Bank at June 30, 2008 and December 31, 2007 with the minimum regulatory guidelines were as follows:

|   | <i>(dollars in thousands)</i> |        |                             |       |  |        |
|---|-------------------------------|--------|-----------------------------|-------|--|--------|
|   | Actual                        |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|   | Amount                        | Ratio  | Amount                      | Ratio | Amount   | Ratio  |
| <b>June 30, 2008:</b>                     |                               |        |                             |       |  |        |
| Total Capital (to Risk Weighted Assets):  |                               |        |                             |       |  |        |
| Consolidated                              | \$ 54,088                     | 11.58% | \$ 37,366                   | 8.00% | N/A  | N/A    |
| First Bank                                | \$ 53,425                     | 11.45% | \$ 37,324                   | 8.00% | \$ 46,655  | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets): |                               |        |                             |       |  |        |
| Consolidated                              | \$ 49,608                     | 10.62% | \$ 18,683                   | 4.00% | N/A  | N/A    |
| First Bank                                | \$ 48,945                     | 10.49% | \$ 18,662                   | 4.00% | \$ 27,993  | 6.00%  |
| Tier 1 Capital (to Average Assets):       |                               |        |                             |       |  |        |
| Consolidated                              | \$ 49,608                     | 9.28%  | \$ 21,375                   | 4.00% | N/A  | N/A    |
| First Bank                                | \$ 48,945                     | 9.17%  | \$ 21,355                   | 4.00% | \$ 26,694  | 5.00%  |
| <b>December 31, 2007:</b>                 |                               |        |                             |       |  |        |
| Total Capital (to Risk Weighted Assets):  |                               |        |                             |       |  |        |
| Consolidated                              | \$ 54,922                     | 11.80% | \$ 37,250                   | 8.00% | N/A  | N/A    |
| First Bank                                | \$ 54,136                     | 11.64% | \$ 37,196                   | 8.00% | \$ 46,496  | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets): |                               |        |                             |       |  |        |
| Consolidated                              | \$ 50,715                     | 10.89% | \$ 18,625                   | 4.00% | N/A  | N/A    |
| First Bank                                | \$ 49,929                     | 10.74% | \$ 18,598                   | 4.00% | \$ 27,897  | 6.00%  |
| Tier 1 Capital (to Average Assets):       |                               |        |                             |       |  |        |
| Consolidated                              | \$ 50,715                     | 9.53%  | \$ 21,288                   | 4.00% | N/A  | N/A    |
| First Bank                                | \$ 49,929                     | 9.40%  | \$ 21,257                   | 4.00% | \$ 26,571  | 5.00%  |

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***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. 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, 2008 was 5.41%. The securities have a mandatory redemption date of June 17, 2034, and are subject to varying call provisions beginning 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, 2008, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

On March 11, 2003, First National (VA) Statutory Trust I (Trust I), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On March 26, 2003, \$3.0 million of trust preferred securities were issued through a pooled underwriting. The securities had a LIBOR-indexed floating rate of interest. The securities had a mandatory redemption date of March 26, 2033, and were subject to varying call provisions beginning March 26, 2008. The principal asset of Trust I was \$3.1 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 were fully and unconditionally guaranteed by the Company. The Company redeemed the securities in whole on March 26, 2008.

**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, 2008 and 2007 were as follows:

| For the three months ended<br>June 30, | For the six months ended<br>June 30, |
|--|--------------------------------------|
|--|--------------------------------------|

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|  | 2008      | 2007      | 2008       | 2007       |
|--|-----------|-----------|------------|------------|
| Service cost                                 | \$ 75,352 | \$ 69,784 | \$ 150,704 | \$ 139,568 |
| Interest cost                                | 66,604    | 66,193    | 133,208    | 132,386    |
| Expected return on plan assets               | (87,771)  | (63,674)  | (175,542)  | (127,348)  |
| Amortization of prior service cost           | 818       | 818       | 1,636      | 1,636      |
| Amortization of net obligation at transition | (1,407)   | (1,407)   | (2,814)    | (2,814)    |
| Amortization of net loss                     | 3,326     | 10,569    | 6,652      | 21,138     |
| Net periodic benefit cost                    | \$ 56,922 | \$ 82,283 | \$ 113,844 | \$ 164,566 |

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**Notes to Consolidated Financial Statements**

*(unaudited)*

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2007, that it expected to contribute \$228 thousand to its pension plan for the 2008 plan year. The Company did not make a contribution to the pension plan for the 2008 plan year during the second quarter of 2008. The Company is planning to make the contribution for the 2008 plan year during the fourth quarter of 2008.

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, 2007 for additional information about the Company's benefit plans.

**Note 9. Earnings per Share**

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per 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, 2007 for additional information about the Company's leveraged ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per share were 2,912,172 and 2,905,574 for the three months ended June 30, 2008 and 2007, respectively and 2,911,323 and 2,904,786 for the six months ended June 30, 2008 and 2007, respectively.

**Note 10. Fair Value Measurements**

SFAS No. 157, Fair Value Measurements, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

**Securities**

Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are



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classified within level 3 of the valuation hierarchy. Currently, all of the Company's securities are considered to be Level 2 securities.

### Loans held for sale

Loans held for sale are required to be measured at lower of cost or fair value. Under SFAS No. 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At June 30, 2008, the entire balance of loans held for sale was recorded at its cost.

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### **Impaired loans**

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

### **Other Real Estate Owned**

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

## **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 other similar 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;

successful management of credit risk including certain concentrations in loans secured by real estate;

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;

competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital, liquidity and other resources;

the ability to successfully manage and implement balance sheet growth strategies;

the successful management of interest rate risk;

maintaining capital levels adequate to support growth;

reliance on the management team, including the ability to attract and retain key personnel; and

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the limited trading market in the Company's common stock.

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, 2008 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, 2007. The results of operations for the three and six month periods ended June 30, 2008 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), First National (VA) Statutory Trust II (Trust II) and First National (VA) Statutory Trust III (Trust III). The Trusts were formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. The Bank owns First Bank Financial Services, Inc., which invests in partnerships that provide title insurance and investment services.

#### Products, Services, Customers and Locations

The Bank offers loan, deposit, trust and investment products and services through 11 offices, 29 ATMs and its website, [www.firstbank-va.com](http://www.firstbank-va.com). Customers include individuals, small and medium-sized businesses and governmental entities in the northern Shenandoah Valley region of Virginia.

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### 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 represented approximately 75% of the Company's total revenue for the three month period ended June 30, 2008. 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 another important 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 services and investment advisory services and through the origination and sale of residential mortgages.

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by 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 three month period ended June 30, 2008 is salaries and employee benefits, comprising 56% of noninterest expenses, followed by occupancy and equipment expense, comprising 16% of expenses.

### Quarterly Performance

Net income totaled \$1.4 million, or \$0.48 per basic and diluted share, for the quarter ended June 30, 2008. This was an increase of 9% compared to \$1.3 million, or \$0.44 per basic and diluted share, for the same period in 2007. Net interest income and noninterest income increased 3% and 7%, respectively, while noninterest expense only increased 2% when comparing the same periods. Return on assets and return on equity were 1.05% and 14.23%, respectively, for the second quarter of 2008 compared to 0.98% and 15.10% for the same quarter in 2007.

Comparing the quarter ended June 30, 2008 to the quarter ended June 30, 2007, net interest income increased 3% as a result of a 5 basis point increase in the net interest margin and an \$11.5 million increase in average earning assets. The improvement in the net interest margin was primarily due to a decrease in funding costs that exceeded the decrease in the yield on interest-earning assets. These decreases resulted from lower market rates during the second quarter of 2008 compared to the same period in 2007. The federal funds rate was down 325 basis points compared to one year ago.

Loan growth and net charge-offs resulted in a provision for loan losses of \$84 thousand for the three months ended June 30, 2008 compared to \$67 thousand for the same period in 2007. Non-performing assets totaled \$8.0 million, compared to \$8.5 million at March 31, 2008 and \$1.6 million at June 30, 2007. The higher levels of non-performing assets were primarily attributable to the contraction of the local housing market and the impact to local builders and real estate developers. As a result of the factors above, the allowance for loan losses increased to \$4.5 million or 0.99% of total loans at June 30, 2008, up from \$4.2 million or 0.94% of total loans at December 31, 2007. Management has worked hard to identify, evaluate and monitor loans with higher levels of risk, and as a result, remains confident about the overall quality of the loan portfolio.

Noninterest income increased 7% for the second quarter of 2008 compared to the same quarter of 2007 due to increases in fees from loans, ATM and check card activity. Noninterest expense increased 2% for the second quarter of 2008 compared to the same period in 2007.

### Year-to-Date Performance

For the six months ended June 30, 2008, net income increased 5% to \$2.8 million, or \$0.97 per basic and diluted share, compared to \$2.7 million, or \$0.92 per basic and diluted share, for the same period in 2007. Earnings improved as a result of increases in net interest income and noninterest income of 6% and 11%, respectively, offset by a 5% increase in noninterest expense and a significant increase in the provision for loan losses. Return on assets and return on equity were 1.05% and 14.45%, respectively, for the first six months of 2008 compared to 1.04% and 16.13% for the same period in 2007.

Net interest income increased 6% to \$9.2 million for the six months ended June 30, 2008, compared to \$8.8 million for the same period in 2007. This increase was the result of a 9 basis point increase in the net interest margin and a \$14.4 million increase in average interest-earning assets when comparing the two periods. The improvement in the net interest margin was primarily due to a decrease in funding costs that exceeded the decrease in the yield on interest-earning assets. These decreases resulted from lower market rates during the first six months of 2008 compared to the same period in 2007. The net interest margin was 3.73% for the six months ended June 30, 2008, compared to 3.64% for the same period in 2007.



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Noninterest income increased 11% to \$3.0 million for the six months ended June 30, 2008 from \$2.7 million for the same period in 2007. Fees for other customer services increased 22% to \$754 thousand compared to \$618 thousand for the same period in 2007. This increase was attributable to increases in fee income from ATM and check card fees. Fee income from trust and investment advisory services increased 23% to \$686 thousand for the six months ended June 30, 2008, compared to \$559 thousand for the same period in 2007.

For the six months ended June 30, 2008, noninterest expense increased 5% to \$7.8 million, compared to \$7.5 million for the same period in 2007 primarily from higher salary and benefit expenses in 2008. The additional salary and benefit expense resulted from annual salary adjustments.

Total assets were \$540.2 million at June 30, 2008 compared to \$541.6 million at December 31, 2007. A decrease in deposit balances and low demand for loans has resulted in no balance sheet growth. The Company's trust and investment advisory group had assets under management of \$208.2 million at June 30, 2008 compared to \$200.1 million at December 31, 2007. These assets are managed by the trust and asset management department and are not held on the Company's balance sheet.

## **Management Outlook**

The Company expects balance sheet growth during 2008 to be less than 2007 based on economic conditions and the impact on the local market. The contraction of the housing market has directly impacted customers in the construction and land development business, while indirectly impacting others. Based on Company forecasts, the net interest margin is expected to remain relatively stable as the spread between yields on earning assets and interest-bearing liabilities is not expected to change significantly. However, competitive pressure on deposit rates in the local market could have a negative impact on net interest income.

Changing economic conditions, which are caused by factors beyond the Company's control, may have a direct correlation with the required provision for loan losses. However, the Company believes that it has identified the loans with the highest risk and has appropriately increased the allowance for loan losses during the first six months of the year. Because the allowance for loan losses has increased significantly and the Company does not expect substantial loan growth during the remainder of 2008, the provision for loan losses is expected to be lower during the second half of 2008 compared to the first half.

The rate of growth in noninterest income is expected to slow in future periods as the trust department is no longer experiencing rapid growth. The department began operations in 2005 and experienced high growth rates during 2005 and 2006 from initial market demand. The Company does not expect significant increases in noninterest expense during the remainder of 2008. The Company is focused on leveraging existing branches and does not plan to expand its branch network in the near term. However, an operations center has been built and was placed in service during the third quarter of 2008. The new operations center will support future growth and should facilitate efficiencies. The center is not anticipated to increase expenses because the Company is not hiring additional staff.

## **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-equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax-equivalent net interest income is considered in the calculation of this ratio. Tax-equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2008 and 2007 is 34%. The reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below.

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|  | <b>Reconciliation of Net Interest Income to<br/>Tax-Equivalent Net Interest Income</b> |                          |                                 |                          |
|--|--|--------------------------|---------------------------------|--------------------------|
|  | <i>(in thousands)</i>  |                          |                                 |                          |
|  | <b>For the three months ended</b>  |                          | <b>For the six months ended</b> |                          |
|  | <b>June 30,<br/>2008</b>   | <b>June 30,<br/>2007</b> | <b>June 30,<br/>2008</b>        | <b>June 30,<br/>2007</b> |
| <b>GAAP measures:</b>  |  |                          |                                 |                          |
| Interest income - loans  | \$ 6,882   | \$ 8,065                 | \$ 14,600                       | \$ 16,018                |
| Interest income - investments and other                                    | 682  | 734                      | 1,404                           | 1,470                    |
| Interest expense - deposits  | 2,339  | 3,551                    | 5,372                           | 7,093                    |
| Interest expense - other borrowings  | 454  | 538                      | 967                             | 1,088                    |
| Interest expense - other   | 191  | 279                      | 433                             | 554                      |
| <b>Total net interest income</b>   | <b>\$ 4,580</b>  | <b>\$ 4,431</b>          | <b>\$ 9,232</b>                 | <b>\$ 8,753</b>          |
| <b>Non-GAAP measures:</b>  |  |                          |                                 |                          |
| Tax benefit realized on non-taxable interest income - loans                | \$ 10  | \$ 12                    | \$ 22                           | \$ 24                    |
| Tax benefit realized on non-taxable interest income - municipal securities | 68   | 60                       | 136                             | 119                      |
| <b>Total tax benefit realized on non-taxable interest income</b>           | <b>\$ 78</b>   | <b>\$ 72</b>             | <b>\$ 158</b>                   | <b>\$ 143</b>            |
| <b>Total tax-equivalent net interest income</b>                            | <b>\$ 4,658</b>  | <b>\$ 4,503</b>          | <b>\$ 9,390</b>                 | <b>\$ 8,896</b>          |

**Critical Accounting Policies**General

The Company's consolidated financial statements and related notes are prepared in accordance with GAAP. The financial information contained within the statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. The Bank uses historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from the historical factors used. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact transactions could change. For further information about the Bank's loans and the allowance for loan losses, see Notes 3 and 4 to consolidated financial statements, included in Item 1 of this Form 10-Q.

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

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on three basic principles of accounting: (1) Statement of Financial Accounting Standards (SFAS) No. 5 Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, (2) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance and (3) U.S. Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 102 Selected Loan Loss Allowance Methodology and Documentation Issues, which requires adequate documentation to support the allowance for loan losses estimate.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.





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The Bank's allowance for loan losses has two basic components: the specific allowance and the general allowance. Both of these components are determined based upon estimates that can and do change when the actual events occur. The allowance for loan losses is comprised of the sum of the specific allowance and the general allowance.

The specific allowance is typically used to individually allocate an allowance for larger balance, commercial, non-homogeneous loans. The specific allowance uses various techniques to arrive at an estimate of loss. First, analysis of the borrower's overall financial condition, resources and payment record; the prospects for support from financial guarantors; and the fair market value of collateral, net of selling costs, are used to estimate the probability and severity of inherent losses. Second, historical default rates and loss severities, internal risk ratings, industry and market conditions and trends, and other environmental factors are considered. The use of these values is inherently subjective and actual losses could differ from the estimates.

The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans including residential mortgage loans, installment loans, other consumer loans and outstanding loan commitments. This formula is also used for the remaining pool of larger balance, non-homogeneous loans, which were not allocated a specific allowance upon impairment review. The general allowance begins with estimates of probable losses inherent in the homogeneous portfolio. This includes, but is not limited to, analysis of loss experience over a three-year period, economic conditions, asset quality and collateral value. The general allowance uses a historical loss view as an indicator of future losses. As a result, even though this history is regularly updated with the most recent information, it could differ from the loss incurred in the future.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. The Company does not separately identify individual consumer and residential loans for impairment disclosures.

## **Lending Policies**

### **General**

The principal risk associated with each of the categories of loans in the Bank's portfolio is the creditworthiness of its borrowers. Within each category, such risk is increased or decreased, depending on prevailing economic conditions. The risk associated with real estate mortgage loans and commercial and consumer loans varies, based on economic conditions, fluctuations in the value of real estate and other conditions that affect the ability of borrowers to repay indebtedness. The risk associated with real estate construction loans varies, based on the supply and demand for the type of real estate under construction.

In an effort to manage the risk, the Bank's loan policy authorizes loan amount approval limits for individual loan officers based on their position within the Bank and level of experience. The Bank's Board of Directors and its Loan Committee approve all loan relationships greater than \$1.5 million. The President and CEO and the Executive Vice President - Loan Administration can combine their lending limits to approve loan relationships up to \$1.5 million. All loan relationships greater than \$750 thousand are reported to the Board or its Loan Committee. The Loan Committee consists of five non-management directors and the President and CEO. The Committee approves the Bank's Loan Policy and reviews loans that have been charged-off. It also reviews the allowance for loan loss adequacy calculation as well as the loan watch list and other management reports. The Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

Residential loan originations are primarily generated by Bank loan officer solicitations, referrals by real estate professionals, and customers. Commercial real estate loan originations are obtained through broker referrals, direct solicitation of developers and continued business from customers. All completed loan applications are reviewed by the Bank's loan officers. As part of the application process, information is obtained concerning the income, financial condition, employment and credit history of the applicant. If commercial real estate is involved, information is also obtained concerning cash flow available for debt service. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines as well as the guidelines issued by the purchasers of loans, depending on the type of loan involved. Real estate collateral is appraised by independent fee appraisers who have been pre-approved by the Executive Vice President - Loan Administration.



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In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities that are disclosed but not reflected in its financial statements, including commitments to extend credit. At June 30, 2008, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$61.4 million.

### Commercial Business Lending

Commercial business loans generally have a higher degree of risk than loans secured by real estate, but typically have higher yields. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. At June 30, 2008, commercial loans not secured by real estate totaled \$53.6 million, or 12% of total loans, as compared to \$53.0 million, or 12%, at December 31, 2007.

### Commercial Real Estate Lending

Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. At June 30, 2008, commercial real estate loans totaled \$194.0 million or 43% of the Bank's total loans, as compared to \$194.4 million, or 43%, at December 31, 2007. In its underwriting of commercial real estate, the Bank may lend, under federal regulation, up to 85% of the secured property's appraised value, although the Bank's loan to original appraised value ratio on such properties is typically 80% or less. Commercial real estate lending entails significant additional risk, compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the payment experience on loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy, in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrower's principal owners and carefully evaluates the location and environmental condition of the real estate collateral. To further mitigate risk, the Company monitors loan concentrations within the commercial real estate portfolio.

### Construction Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. Construction and land development loans outstanding at June 30, 2008 and December 31, 2007, were \$71.6 million, or 16% of total loans, and \$73.5 million, or 16% of total loans, respectively. The majority of these loans has an average life of approximately one year and reprice monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, requires personal guarantees from the borrower's principal owners, and monitors the progress of the construction project during the draw period.

### Residential Real Estate Lending

Residential lending activity may be generated by Bank loan officer solicitations, referrals by real estate professionals, and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank's underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. The valuation of residential collateral is provided by independent fee appraisers who have been approved by the Bank's Executive Vice President-Loan Administration.



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Typically, the Bank originates all fixed rate mortgage loans with the intent to sell to correspondent lenders. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans. At June 30, 2008, \$111.0 million, or 25%, of total loans consisted of one-to-four-family residential real estate loans as compared to \$106.4 million, or 24%, at December 31, 2007.

In connection with residential real estate loans, the Bank requires title insurance, hazard insurance and, if required, flood insurance. Flood determination letters with life of loan tracking are obtained on all federally related transactions with improvements serving as security for the transaction. The Bank does not require escrows for real estate taxes and insurance for secondary market loans.

The Company does not participate in sub-prime lending practices so issues recently arising in the residential mortgage market from sub-prime lending are not expected to have a direct impact on earnings. Nevertheless, the Company is subject to risks associated with general economic and business conditions in its market area, as well as the condition of the regional residential mortgage market, each of which may be impacted by sub-prime lending and related issues.

### **Consumer Lending**

The Bank offers various secured and unsecured consumer loans, including unsecured personal loans and lines of credit, automobile loans, deposit account loans and installment and demand loans. At June 30, 2008, consumer loans, including deposit overdraft balances, were \$16.5 million, or 4% of gross loans, as compared to \$18.8 million, or 4%, at December 31, 2007.

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

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

## **Results of Operations**

### **General**

Net interest income represents the primary source of earnings for the Company. Net interest income equals the amount by which interest income on interest-earning assets, predominantly loans and securities, exceeds interest expense on interest-bearing liabilities, including deposits, other borrowings and trust preferred securities. Changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as their respective yields and rates, are the components that impact the level of net interest income. The net interest margin is calculated by dividing tax-equivalent net interest income by average earning assets. The provision for loan losses, noninterest income and noninterest expense are the other components that determine net income. Noninterest income and expense primarily consists of income from service charges on deposit accounts; fees charged for other customer services, including trust, asset management and brokerage fee income; gains and losses from the sale of assets, including loans held for sale, securities and premises and equipment; general and administrative expenses; and income tax expense.

Net income totaled \$1.4 million, or \$0.48 per basic and diluted share, for the quarter ended June 30, 2008. This was a 9% increase compared to \$1.3 million, or \$0.44 per basic and diluted share, for the same period in 2007. Net interest income and noninterest income increased 3% and 7%, respectively, which was offset by a 2% increase in noninterest expense and a 25% increase in the provision for loan losses when comparing the same periods. Return on assets and return on equity were 1.05% and 14.23%, respectively, for the second quarter of 2008 compared to 0.98% and 15.10% for the same quarter in 2007.

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For the six months ended June 30, 2008, net income increased 5% to \$2.8 million, or \$0.97 per basic and diluted share, compared to \$2.7 million, or \$0.92 per basic and diluted share, for the same period in 2007. Earnings improved as a result of increases in net interest income and noninterest income of 6% and 11%, respectively, offset by a 5% increase in noninterest expense. In addition, the provision for loan losses increased \$287 thousand for the six months ended June 30, 2008, compared to the same period in 2007. Return on assets and return on equity were 1.05% and 14.45%, respectively, for the first six months of 2008 compared to 1.04% and 16.13% for the same period in 2007.

### Net Interest Income

Net interest income increased 3% to \$4.6 million for the second quarter of 2008 compared to \$4.4 million for the same quarter of 2007. This increase was the result of a 5 basis point increase in the net interest margin and an \$11.5 million increase in average earning assets when comparing the two periods. The net interest margin was 3.71% for the second quarter of 2008, compared to 3.66% for the same period in 2007. The improvement in the net interest margin was primarily due to a decrease in funding costs that exceeded the decrease in the yield on interest-earning assets. These decreases resulted from lower market rates during the second quarter of 2008 compared to the same period in 2007.

Net interest income increased 6% to \$9.2 million for the six months ended June 30, 2008, compared to \$8.8 million for the same period in 2007. This increase was the result of a 9 basis point increase in the net interest margin and a \$14.4 million increase in average interest-earning assets when comparing the two periods. The improvement in the net interest margin was primarily due to a decrease in funding costs that exceeded the decrease in the yield on interest-earning assets. These decreases resulted from lower market rates during the first six months of 2008 compared to the same period in 2007. The net interest margin was 3.73% for the six months ended June 30, 2008, compared to 3.64% for the same period in 2007.

The Company does not anticipate significant changes in the net interest margin during the remainder of 2008. However, increasing competitive pressure on deposit rates in the local market could have a negative impact on net interest income.

### Provision for Loan Losses

Loan growth and net charge-offs resulted in a provision for loan losses of \$84 thousand for the three months ended June 30, 2008 compared to \$67 thousand for the same period in 2007. For the six months ended June 30, 2008, the provision for loan losses was \$354 thousand, compared to \$67 thousand for the same period in 2007. Non-performing assets totaled \$8.0 million, compared to \$2.3 million at December 31, 2007 and \$1.6 million at June 30, 2007. The higher levels of non-performing assets were primarily attributable to the contraction of the local housing market and the impact to local builders and real estate developers. As a result of the factors above, the allowance for loan losses increased to \$4.5 million or 0.99% of total loans at June 30, 2008, up from \$4.2 million or 0.94% of total loans at December 31, 2007. Management has worked hard to identify, evaluate and monitor loans with higher levels of risk, and as a result, remains confident about the overall quality of the loan portfolio.

Changing economic conditions, which are caused by factors beyond the Company's control, may have a direct correlation with the required provision for loan losses. However, the Company believes that it has identified the loans with the highest risk profiles and appropriately increased the allowance for loan losses during the first half of 2008. Because the allowance for loan losses has increased significantly for the identified problem loans, and the Company expects less loan growth during 2008 compared to 2007, the provision for loan losses is not expected to increase significantly during the remainder of this year.

### Noninterest Income

Noninterest income increased 7% to \$1.5 million for the second quarter of 2008, compared to \$1.4 million for the same quarter of 2007. Fees for other customer services increased 31% to \$417 thousand for the second quarter of 2008, compared to \$319 thousand for the same period in 2007. This increase resulted from an increase in loan fees and ATM and check card fees. Fee income from trust and investment advisory services increased 26% to \$356 thousand for the second quarter of 2008, compared to \$282 thousand for the same period in 2007. Service charge income decreased 8% to \$708 thousand for the second quarter of 2008, compared to \$772 thousand for the same period in 2007 primarily due to a decrease in overdraft fee income.

Noninterest income increased 11% to \$3.0 million for the six months ended June 30, 2008 from \$2.7 million for the same period in 2007. Fees for other customer services increased 22% to \$754 thousand compared to \$618 thousand for the same period in 2007. This increase was attributable to increases in ATM and check card fees. Fee income from trust and investment advisory services increased 23% to \$686 thousand for the six months ended June 30, 2008, compared to \$559 thousand for the same period in 2007.



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The rate of growth in noninterest income is expected to slow in future periods, primarily because the trust department is no longer experiencing rapid growth. The department began operations in 2005 and experienced high growth rates during 2005 and 2006 from initial market demand.

### **Noninterest Expense**

Noninterest expense increased 2% to \$4.0 million for the second quarter of 2008 compared to \$3.9 million for the same period in 2007. The Company has been diligent in managing expenses during the first six months of 2008.

For the six months ended June 30, 2008, noninterest expense increased 5% to \$7.8 million, compared to \$7.5 million for the same period in 2007 primarily from higher salary and employee benefit expenses in 2008. The additional expense resulted from annual salary adjustments.

The Company does not expect significant increases in noninterest expense during the remainder of 2008. The Company is focused on leveraging existing branches and does not plan to expand its branch network in the near term. However, an operations center has been built and was placed in service during the third quarter of this year. The new operations center will support future growth and should facilitate efficiencies. The center is not anticipated to increase expenses because the Company is not hiring additional staff.

### **Income Taxes**

The Company's income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the three and six month periods ended June 30, 2008 and 2007. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income. The effective income tax rate was 31.8% and 32.4% for the three months ended June 30, 2008 and 2007, respectively, and 31.7% and 32.3% for the six months ended June 30, 2008 and 2007, respectively. A more detailed discussion of the Company's tax calculation is contained in Note 9 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

## **Financial Condition**

### **General**

Total assets were \$540.2 million at June 30, 2008 compared to \$541.6 million at December 31, 2007. A decrease in deposit balances and low demand for loans has resulted in no balance sheet growth. The Company's trust and investment advisory group had assets under management of \$208.2 million at June 30, 2008 compared to \$200.1 million at December 31, 2007. These assets are managed by the trust and asset management department and are not held on the Company's balance sheet.

The Company expects balance sheet growth during 2008 to be less than 2007. This is based on economic conditions and their impact on the local market. The contraction of the housing market has directly impacted customers in the construction and land development business, while indirectly impacting others. Deposit balances and loan demand have declined during the first six months of 2008, and the Company does not anticipate improvement during the remainder of the year.

### **Loans**

The Bank is an active lender with a loan portfolio that includes commercial and residential real estate loans, commercial loans, consumer loans, real estate construction loans and home equity loans. The Bank's lending activity is concentrated on individuals, small and medium-sized businesses and local governmental entities in its market area. As a provider of community-oriented financial services, the Bank does not attempt to geographically diversify its loan portfolio by undertaking significant lending activity outside its market area. Loans, net of the allowance for loan losses, were \$445.4 million at June 30, 2008 and December 31, 2007.

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$376.5 million, or 83.7% of total loans and \$374.3 million, or 83.2% of total loans at June 30, 2008 and December 31, 2007, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be affected by local economic conditions. Construction loans totaled \$71.6 million and \$73.5 million, or 15.9% and 16.3% of total loans at June 30, 2008 and December 31, 2007, respectively.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$44.9 million at June 30, 2008, representing 114.0% of total shareholders' equity and 10.0% of total loans. At December 31, 2007, this concentration



totaled \$43.4 million representing 114.7% of total shareholders' equity and 9.6% of total loans. These loans are

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included in other real estate loans in the table found in Note 3 of the notes to consolidated financial statements of this Form 10-Q. The Company experienced no loan losses related to this concentration of credit risk during the three and six month periods ended June 30, 2008 and the year ended December 31, 2007. The Company's Board of Directors monitors this concentration on a quarterly basis.

### Asset Quality

Management classifies as nonperforming assets both loans on which payment has been delinquent 90 days or more and loans for which there is a risk of loss to either principal or interest, and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. OREO is recorded at the lower of cost or market, less estimated selling costs, and is actively marketed by the Bank through brokerage channels. The Bank had \$377 thousand in foreclosed real estate at June 30, 2008 and December 31, 2007.

Nonperforming assets were \$8.0 million at June 30, 2008, \$2.3 million at December 31, 2007 and \$1.6 million at June 30, 2007, representing 1.77%, 0.50% and 0.36% of total loans, respectively. Nonperforming assets at June 30, 2008 consisted primarily of commercial real estate loans. The increase in nonperforming assets was a factor that determined the provision for loan losses during the first six months of this year. Nonperforming assets could increase due to other potential problem loans identified by management totaling \$4.8 million at June 30, 2008. Certain risks, including the borrower's ability to pay and the collateral value securing the loan, have been identified that may result in the potential problem loans not being repaid in accordance with their terms. However, the loans are currently performing and \$3.8 million of the potential problem loans are considered well-secured.

The provision for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$4.5 million at June 30, 2008 and \$4.2 million at December 31, 2007, representing 0.99% and 0.94% of total loans, respectively.

Impaired loans totaled \$7.1 million and \$3.3 million at June 30, 2008 and December 31, 2007, respectively. These loans have been recognized in conformity with SFAS No. 114. The related allowance for loan losses provided for these loans totaled \$118 thousand and \$12 thousand at June 30, 2008 and December 31, 2007, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2008 and the year ended December 31, 2007 was \$4.6 million and \$952 thousand, respectively.

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

### Securities

Securities at June 30, 2008 were \$56.3 million, a 2% decrease from \$57.5 million at December 31, 2007. The Company plans to maintain its current level of securities in relation to total assets in order to maintain liquidity ratios that are required by Company policy. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and certain restricted securities. As of June 30, 2008, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios.

### Deposits

Deposits were \$425.7 million at June 30, 2008, a \$19.4 million decrease from \$445.1 million at December 31, 2007. Non-interest bearing demand deposits increased \$10.6 million or 13% during the first six months of 2008. Time deposits decreased \$6.1 million or 3% during the first six months of 2008 to \$182.9 million compared to \$189.0 million at December 31, 2007. Savings and interest-bearing demand deposits decreased \$23.9 million or 13% when comparing the same periods. Although the Company plans to fund future asset growth with deposits, competition in the Company's market area has increased. This will likely make funding assets with local deposits challenging, without a negative impact to the net interest margin.



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### Liquidity

Liquidity represents the ability to meet present and future financial obligations through either the sale or maturity of existing assets or with borrowings from correspondent banks or other deposit markets. Liquid assets include cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, investment securities and loans maturing within one year. As a result of the Bank's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' borrowing needs.

At June 30, 2008, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, loans maturing within one year, and expected maturities, calls and principal repayments from the securities portfolio within one year totaled \$160.2 million. At June 30, 2008, 33% or \$149.0 million of the loan portfolio would mature within one year. At June 30, 2008, non-deposit sources of available funds totaled \$60.3 million, which included \$46.5 million available from FHLB. During the first six months of 2008, other borrowing activity included repayment of a fixed rate advance from FHLB in the amount of \$10.0 million and borrowing \$10.0 million on a fixed rate advance from FHLB. The Bank also borrowed and repaid Daily Rate Credit advances as an alternative to purchasing federal funds.

### Company Obligated Mandatorily Redeemable Capital Securities

The Company redeemed \$3.1 million of junior subordinated debt securities, in whole, on March 26, 2008. The Company remained well-capitalized on the redemption date and at June 30, 2008. For further information, see Note 7 of the notes to consolidated financial statements of this Form 10-Q.

### Capital Resources

The adequacy of the Company's capital is reviewed by management on an ongoing basis with reference to the size, composition, and quality of the Company's asset and liability levels and consistent with regulatory requirements and industry standards. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and absorb potential losses.

The Board of Governors of the Federal Reserve System has adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.00%, of which at least 4.00% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. The Company had a ratio of total capital to risk-weighted assets of 11.58% at June 30, 2008 and a ratio of Tier 1 capital to risk-weighted assets of 10.62%. Both of these exceed the capital requirements adopted by the federal regulatory agencies.

### Contractual Obligations

There have been no material changes outside the ordinary course of business to the contractual obligations disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

### Off-Balance Sheet Arrangements

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

Commitments to extend credit, which amounted to \$53.5 million at June 30, 2008, and \$70.2 million at December 31, 2007, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.



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

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At June 30, 2008 and December 31, 2007, the Bank had \$6.1 million and \$7.2 million in outstanding standby letters of credit, respectively.

At June 30, 2008 and December 31, 2007, the Company had entered into locked-rate commitments to originate mortgage loans amounting to \$1.8 million and \$673 thousand, respectively. The Company had loans held for sale of \$457 thousand and \$270 thousand at June 30, 2008 and December 31, 2007, respectively. The Company has entered into commitments, on a best-effort basis to sell loans of approximately \$1.8 million. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

**Recent Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), *Business Combinations* (SFAS 141(R)). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction; establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder's fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and early implementation is not permitted. The Company does not expect the implementation to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 requires the Bank (Company) to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

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

Not required.

**Item 4. Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods required by the SEC. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2008 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.



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

**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There are no material changes to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

The Company held its annual meeting of shareholders on May 13, 2008. The following matter was voted on during the meeting:

The election of the 11 directors to serve for a term of one year:

|                       | <b>For</b> | <b>Withheld</b> |
|-----------------------|------------|-----------------|
| Douglas C. Arthur     | 2,354,202  | 25,354          |
| Byron A. Brill        | 2,342,519  | 37,038          |
| Elizabeth H. Cottrell | 2,352,525  | 27,032          |
| James A. Davis        | 2,356,362  | 23,195          |
| Christopher E. French | 2,354,362  | 25,295          |
| John K. Marlow        | 2,356,362  | 23,195          |
| W. Allen Nicholls     | 2,349,840  | 29,716          |
| Henry L. Shirkey      | 2,354,563  | 24,993          |
| Gerald F. Smith, Jr.  | 2,354,262  | 25,295          |
| Harry S. Smith        | 2,345,358  | 34,198          |
| James R. Wilkins, III | 2,356,241  | 23,315          |

**Item 5. Other Information**

None.





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**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

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**SIGNATURES**

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

**FIRST NATIONAL CORPORATION**

(Registrant)

/s/ Harry S. Smith

Harry S. Smith

President and Chief Executive Officer

August 12, 2008

Date

/s/ M. Shane Bell

M. Shane Bell

Executive Vice President and Chief Financial Officer

August 12, 2008

Date

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**EXHIBIT INDEX**

| <b>Number</b> | <b>Document</b>   |
|---------------|---|
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