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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2016

or

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

For the transition period from _____ to _____

Commission file number 0-23976



(Exact name of registrant as specified in its charter)

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

Registrant's telephone number, including area code: (540) 465-9121

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$1.25 par value
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this Chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this Chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing sales price on June 30, 2016 was \$39,525,026.

The number of outstanding shares of common stock as of March 29, 2017 was 4,940,766.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for the 2017 Annual Meeting of Shareholders – Part III

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Part I

Cautionary Statement Regarding Forward-Looking Statements

First National Corporation (the Company) makes forward-looking statements in this Form 10-K that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, adequacy of capital, allowance for loan losses, interest rate sensitivity, market risk, growth strategy and financial and other goals. The words “believes,” “expects,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “forecasts,” “intends,” or other similar words or 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:

- conditions in the financial markets and economic conditions may adversely affect the Company’s business;
- the inability of the Company to successfully manage its growth or implement its growth strategy;
- difficulties in combining the operations of acquired bank branches or entities with the Company’s own operations;
- the Company’s inability to successfully obtain the expected benefits of the acquisition of bank branches or entities;
- intense competition from other businesses both in making loans and attracting deposits;
- consumers may increasingly decide not to use the Bank to complete their financial transactions;
- limited availability of financing or inability to raise capital;
- exposure to operational, technological, and organizational risk;
- reliance on other companies to provide key components of their business infrastructure;
- the Company’s credit standards and its on-going credit assessment processes might not protect it from significant credit losses;
- operational functions of business counterparties over which the Company may have limited or no control may experience disruptions;
- nonperforming assets take significant time to resolve and adversely affect the Company’s results of operations and financial condition;
- allowance for loan losses may prove to be insufficient to absorb losses in the loan portfolio;
- the concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets;
- legislative or regulatory changes or actions, or significant litigation;
- the limited trading market for the Company’s common stock; it may be difficult to sell shares;
- unexpected loss of management personnel;
- losses that could arise from breaches in cyber-security and theft of customer account information;
- increases in FDIC insurance premiums could adversely affect the Company’s profitability;
- the ability to retain customers and secondary funding sources if the Bank’s reputation would become damaged;
- changes in interest rates could have a negative impact on the Company’s net interest income and an unfavorable impact on the Bank’s customers’ ability to repay loans; and
- other factors identified in Item 1A, “Risk Factors”, below.

Because of these and other 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.

Item 1. Business

General

First National Corporation (the Company) is a bank holding company incorporated under Virginia law on September 7, 1983. The Company owns all of the stock of its primary operating subsidiary, First Bank (the Bank), which is a commercial bank chartered under Virginia law. The Company's subsidiaries are:

- First Bank (the Bank). The Bank owns:
- First Bank Financial Services, Inc.
- Shen-Valley Land Holdings, LLC
- First National (VA) Statutory Trust II (Trust II)
- First National (VA) Statutory Trust III (Trust III)

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First Bank Financial Services, Inc. invests in entities that provide title insurance and investment services. Shen-Valley Land Holdings, LLC was formed to hold other real estate owned and future office sites. The Trusts were formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities and are not included in the Company's consolidated financial statements in accordance with authoritative accounting guidance because management has determined that the Trusts qualify as variable interest entities.

The Bank first opened for business on July 1, 1907 under the name The Peoples National Bank of Strasburg. On January 10, 1928, the Bank changed its name to The First National Bank of Strasburg. On April 12, 1994, the Bank received approval from the Federal Reserve Bank of Richmond (the Federal Reserve) and the Virginia State Corporation Commission's Bureau of Financial Institutions to convert to a state chartered bank with membership in the Federal Reserve System. On June 1, 1994, the Bank consummated such conversion and changed its name to First Bank.

Access to Filings

The Company's internet address is www.fbvirginia.com. The Company's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to those reports, as filed with or furnished to the Securities and Exchange Commission (the SEC), are available free of charge at www.fbvirginia.com as soon as reasonably practicable after being filed with or furnished to the SEC. A copy of any of the Company's filings will be sent, without charge, to any shareholder upon written request to: M. Shane Bell, Chief Financial Officer, at 112 West King Street, Strasburg, Virginia 22657.

Products and Services

The Bank provides loan, deposit, wealth management and other products and services in the Shenandoah Valley and central regions of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, money market accounts, individual retirement accounts, certificates of deposit and cash management accounts.

The Bank's wealth management department offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. The Bank's mortgage department originates residential mortgage loans to customers. Loans originated through this department may be sold to investors in the secondary market or held in the Bank's loan portfolio. Mortgage services are offered to customers throughout the Bank's market area.

The Bank's office locations are well-positioned in attractive markets along the Interstate 81, Interstate 66, and Interstate 64 corridors in the Shenandoah Valley and central regions of Virginia. Within this market area, there are various types of industry including medical and professional services, manufacturing, retail, government contracting and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

The Bank's products and services are delivered through its mobile banking platform, its website, www.fbvirginia.com, a network of ATMs located throughout its market area, two loan production offices, a customer service center in a retirement village, and 14 bank branch office locations located throughout the Shenandoah Valley and central regions of Virginia. The branch offices are comprised of 13 full service retail banking offices and one drive-thru express banking office. For the location and general character of each of these offices, see Item 2 of this Form 10-K.

Competition

The financial services industry remains highly competitive and is constantly evolving. The Company experiences strong competition in all aspects of its business. In its market areas, the Company competes with large national and regional financial institutions, credit unions, other community banks, as well as consumer finance companies, mortgage companies, mutual funds and life insurance companies. Competition for deposits and loans is affected by various factors including interest rates offered, the number and location of branches and types of products offered, and the reputation of the institution. Credit unions have been allowed to increasingly expand their membership definitions and, because they enjoy a favorable tax status, may be able to offer more attractive loan and deposit pricing.

The Company believes its competitive advantages include long-term customer relationships, local management and directors, a commitment to excellent customer service, dedicated and loyal employees, and the support of and involvement in the communities that the Company serves. The Company focuses on providing products and services to individuals, small to medium-sized businesses, non-profit organizations, and local governmental entities within its communities. The Company's

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primary operating subsidiary, First Bank, generally has a strong deposit share of the markets it serves. According to Federal Deposit Insurance Corporation (FDIC) deposit data as of June 30, 2016, the Bank was ranked third overall in its market area with 11.09% of the total deposit market.

No material part of the business of the Company is dependent upon a single or a few customers, and the loss of any single customer would not have a materially adverse effect upon the business of the Company.

Employees

At December 31, 2016, the Bank employed a total of 153 full-time equivalent employees. The Company considers relations with its employees to be excellent.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively and increasingly regulated under both federal and state laws. The following description briefly addresses certain historic and current provisions of federal and state laws and certain regulations, proposed regulations, and the potential impacts on the Company and the Bank. To the extent statutory or regulatory provisions or proposals are described in this report, the description is qualified in its entirety by reference to the particular statutory or regulatory provisions or proposals.

Regulatory Reform – The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), enacted in 2010, implemented and continues to implement significant changes to the regulation of the financial services industry, including provisions that, among other things:

- Centralize responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau (the CFPB), with broad rulemaking, supervisory and enforcement authority with respect to a wide range of consumer protection laws that apply to providers of consumer financial products and services.
- Smaller financial institutions, including the Bank, continue to be subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.
- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to bank holding companies.
- Require the FDIC to seek to make its capital requirements for banks countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.
- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital.
- Implement corporate governance revisions, including advisory votes on executive compensation by stockholders.
- Established extensive requirements applicable to mortgage lending, including detailed requirements concerning mortgage originator compensation and underwriting, high-cost mortgages, servicing, appraisals, counseling and other matters.
- Make permanent the \$250,000 limit for federal deposit insurance.
- Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

The Dodd-Frank Act amends the Bank Holding Company Act of 1956, as amended (the BHCA) to require the federal financial regulatory agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). The statutory provision is commonly called the “Volcker Rule”. The Federal Reserve Board issued final rules implementing the Volcker Rule on December 10, 2013. The Volcker Rule became effective on July 21, 2012 and the final rules were effective April 1, 2014, but the Federal Reserve Board issued an order extending the period during which institutions have to conform their activities and investments to the requirements of the Volcker Rule to July 21, 2017. We do not currently anticipate that the Volcker Rule will have a material effect on the operations of the holding company or the Bank, as we generally do not engage in activities or hold investments impacted by the Volcker Rule.

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Many aspects of the Dodd-Frank Act still remain subject to rulemaking by various regulatory agencies and could take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry more generally. The changes resulting from the Dodd-Frank Act may affect the profitability of business activities, require changes to certain business practices, impose more stringent capital requirements, liquidity and leverage ratio requirements, or otherwise adversely affect the business of the Company and the Bank. These changes may also require the Company to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and regulatory requirements.

Future Legislation and Regulation

Congress may enact legislation from time to time that affects the regulation of the financial services industry, and state legislatures may enact legislation from time to time affecting the regulation of financial institutions chartered by or operating in those states. Federal and state regulatory agencies also periodically propose and adopt changes to their regulations or change the manner in which existing regulations are applied. The substance or impact of pending or future legislation or regulation, or the application thereof, cannot be predicted, although enactment of any proposed legislation could impact the regulatory structure under which the Company and the Bank operate and may significantly increase costs, impede the efficiency of internal business processes, require an increase in regulatory capital, require modifications to business strategy, and limit the ability to pursue business opportunities in an efficient manner. A change in statutes, regulations or regulatory policies applicable to the Company or the Bank could have a material, adverse effect on the business, financial condition and results of operations of the Company and the Bank.

At this time, it is difficult to predict the legislative and regulatory changes that will result from the combination of a new President of the United States and the first year since 2010 in which both Houses of Congress and the White House have majority memberships from the same political party. In recent years, however, both the new President and senior members of the House of Representatives have advocated for significant reduction of financial services regulation, to include amendments to the Dodd-Frank Act and structural changes to the CFPB. The new administration and Congress also may cause broader economic changes due to changes in governing ideology and governing style. Future legislation, regulation, government policy, and potential litigation could affect the banking industry as a whole, including the business and results of operations of the Company and the Bank, in ways that are difficult to predict.

The Company

General. As a bank holding company registered under the BHCA, the Company is subject to supervision, regulation, and examination by the Federal Reserve. The Company is also registered under the bank holding company laws of Virginia and is subject to supervision, regulation, and examination by the Virginia State Corporation Commission (the SCC).

Permitted Activities. A bank holding company is limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the Federal Reserve determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the Federal Reserve must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the Federal Reserve has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding company may result from such an activity.

Banking Acquisitions; Changes in Control. The BHCA requires, among other things, the prior approval of the Federal Reserve in any case where a bank holding company proposes to (i) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless it already owns a majority of such voting shares), (ii) acquire all or substantially all of the assets of another bank or bank holding company, or (iii) merge or consolidate with any other bank holding company. In determining whether to approve a proposed bank acquisition, the Federal Reserve will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's performance under the Community Reinvestment Act of 1977 (the CRA).

Subject to certain exceptions, the BHCA and the Change in Bank Control Act, together with the applicable regulations, require Federal Reserve approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company's acquiring "control" of a bank or bank holding company. A conclusive presumption of

control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured

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depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered securities under Section 12 of the Securities Exchange Act of 1934 (the Exchange Act) or no other person will own a greater percentage of that class of voting securities immediately after the acquisition. The Company's common stock is registered under Section 12 of the Exchange Act.

Source of Strength. Federal Reserve policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. The federal bank regulatory agencies must still issue regulations to implement the source of strength provisions of the Dodd-Frank Act. Under this requirement, the Company is expected to commit resources to support the Bank, including at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Safety and Soundness. There are a number of obligations and restrictions imposed on bank holding companies and their subsidiary banks by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the Federal Deposit Insurance Corporation (the FDIC) insurance fund in the event of a depository institution default. For example, under the Federal Deposit Insurance Company Improvement Act of 1991, to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any subsidiary bank that may become "undercapitalized" with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal bank regulatory agency up to the lesser of (i) an amount equal to 5% of the institution's total assets at the time the institution became undercapitalized, or (ii) the amount that is necessary (or would have been necessary) to bring the institution into compliance with all applicable capital standards as of the time the institution fails to comply with such capital restoration plan.

Under the Federal Deposit Insurance Act (the FDIA), the federal bank regulatory agencies have adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines.

Capital Requirements. The Federal Reserve imposes certain capital requirements on bank holding companies under the BHCA, including a minimum leverage ratio and a minimum ratio of "qualifying" capital to risk-weighted assets. These requirements are described below under "The Bank-Capital Requirements". Subject to its capital requirements and certain other restrictions, the Company is able to borrow money to make a capital contribution to the Bank, and such loans may be repaid from dividends paid by the Bank to the Company.

Limits on Dividends and Other Payments. The Company is a legal entity, separate and distinct from its subsidiaries. A significant portion of the revenues of the Company result from dividends paid to it by the Bank. There are various legal limitations applicable to the payment of dividends by the Bank to the Company and to the payment of dividends by the Company to its shareholders. The Bank is subject to various statutory restrictions on its ability to pay dividends to the Company. Under the current supervisory practices of the Bank's regulatory agencies, prior approval from those agencies is required if cash dividends declared in any given year exceed net income for that year, plus retained net profits of the two preceding years. The payment of dividends by the Bank or the Company may be limited by other factors, such as requirements to maintain capital above regulatory guidelines. Bank regulatory agencies have the authority to prohibit the Bank or the Company from engaging in an unsafe or unsound practice in conducting their business. The payment of dividends, depending on the financial condition of the Bank, or the Company, could be deemed to constitute such an unsafe or unsound practice.

The Company's subordinated debt is in a superior ownership position compared to its common stock and all current and future junior subordinated debt obligations. Following the occurrence of any event of default on its subordinated debt, the Company may not make any payments on its junior subordinated debt; declare or pay any dividends on its common stock; redeem or otherwise acquire any of its common stock; or make any other distributions with respect to its common stock or set aside any monies or properties for such purposes. The Company is current in its interest payments on subordinated debt.

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Our ability to pay dividends on common stock is also limited by contractual restrictions under our junior subordinated debt. Interest must be paid on the junior subordinated debt before dividends may be paid to common shareholders. The Company is current in its interest payments on junior subordinated debt; however, it has the right to defer distributions on its junior subordinated debt, during which time no dividends may be paid on its common stock. If the Company does not have sufficient earnings in the future and begins to defer distributions on the junior subordinated debt, it will be unable to pay dividends on its common stock until it becomes current on those distributions.

The Bank

General. The Bank is supervised and regularly examined by the Federal Reserve and the SCC. The various laws and regulations administered by the regulatory agencies affect corporate practices, such as the payment of dividends, incurrence of debt, and acquisition of financial institutions and other companies; they also affect business practices, such as the payment of interest on deposits, the charging of interest on loans, types of business conducted, and location of offices. Certain of these law and regulations are referenced above under “The Company.”

Capital Requirements. The Federal Reserve and the other federal banking agencies have issued risk-based and leverage capital guidelines applicable to U. S. banking organizations. In addition, those regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its financial condition or actual or anticipated growth. The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board’s Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital.

In July 2013, the U.S. banking regulators adopted a final rule which implements the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision, and certain changes required by the Dodd-Frank Act. The final rule established an integrated regulatory capital framework and introduces the “Standardized Approach” for risk-weighted assets, which replaced the Basel I risk-based guidance for determining risk-weighted assets as of January 1, 2015, the date the Bank became subject to the new rules. Based on the Bank’s current capital composition and levels, the Bank believes it is in compliance with the requirements as set forth in the final rules.

The rules included new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019, and refined the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Bank under the final rules were as follows: a new common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6% (increased from 4%); a total capital ratio of 8% (unchanged from previous rules); and a Tier 1 leverage ratio of 4% for all institutions. The final rules also established a “capital conservation buffer” above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years, which began on January 1, 2016, as follows: the maximum buffer was 0.625% of risk-weighted assets for 2016, and will be 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: a common equity Tier 1 capital ratio of 7.0%, a Tier 1 capital ratio of 8.5%, and a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions. Management believes, as December 31, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

The following table shows the Bank’s regulatory capital ratios at December 31, 2016:

	<u>First Bank</u>
Total capital to risk-weighted assets	13.47 %
Tier 1 capital to risk-weighted assets	12.38 %
Common equity Tier 1 capital to risk-weighted assets	12.38 %
Tier 1 capital to average assets	8.48 %
Capital conservation buffer ratio(1)	5.47 %

Calculated by subtracting the regulatory minimum capital ratio requirements from the Company’s actual ratio for (1) Common equity Tier 1, Tier 1, and Total risk based capital. The lowest of the three measures represents the Bank’s capital conservation buffer ratio.

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are now

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required to meet the following increased capital level requirements in order to qualify as “well capitalized:” a new common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8% (increased from 6%); a total capital ratio of 10% (unchanged from previous rules); and a Tier 1 leverage ratio of 5% (unchanged from previous rules).

Deposit Insurance. Substantially all of the deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund (the DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. On April 1, 2011, the deposit insurance assessment base changed from total deposits to average total assets minus average tangible equity, pursuant to a rule issued by the FDIC as required by the Dodd-Frank Act.

The FDIA, as amended by the Federal Deposit Insurance Reform Act and the Dodd-Frank Act, requires the FDIC to set a ratio of deposit insurance reserves to estimated insured deposits of at least 1.35%. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank’s capital level and supervisory rating. On February 7, 2011, the FDIC introduced three possible adjustments to an institution’s initial base assessment rate: (i) a decrease of up to five basis points for long-term unsecured debt, including senior unsecured debt (other than debt guaranteed under the Temporary Liquidity Guarantee Program) and subordinated debt and, for small institutions, a portion of Tier 1 capital; (ii) an increase for holding long-term unsecured or subordinated debt issued by other insured depository institutions known as the Depository Institution Debt Adjustment or DIDA; and (iii) for non-Risk Category I institutions, an increase not to exceed 10 basis points for brokered deposits in excess of 10% of domestic deposits.

On April 26, 2016, the FDIC adopted a final rule to amend how small banks are assessed deposit insurance. The final rule, which was effective the quarter after the DIF reached 1.15%, revised the calculation of deposit insurance assessments for insured institutions with less than \$10 billion in assets that have been FDIC insured for at least five years (established small banks). The rule updated the data and revised the methodology that the FDIC uses to determine risk-based assessments to better capture the risk that an established small bank poses to the DIF and to ensure that institutions that take on greater risks have higher assessments. The rule eliminated the previous risk categories in favor of an assessment schedule based on examination ratings and financial modeling. The DIF reached 1.15% effective as of June 30, 2016, lowering the assessment rates to between 1.5 and 16 basis points for institutions in the lowest risk category and 3 to 30 basis points for institutions in the higher risk categories. Due to the Bank’s examination ratings and financial ratios, the Bank experienced lower deposit insurance assessment rates as a result of the changes put into effect on July 1, 2016.

In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately one basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2017 through 2019.

Transactions with Affiliates. Pursuant to Sections 23A and 23B of the Federal Reserve Act and Regulation W, the authority of the Bank to engage in transactions with related parties or “affiliates” or to make loans to insiders is limited. Loan transactions with an affiliate generally must be collateralized and certain transactions between the Bank and its affiliates, including the sale of assets, the payment of money or the provision of services, must be on terms and conditions that are substantially the same, or at least as favorable to the Bank, as those prevailing for comparable nonaffiliated transactions. In addition, the Bank generally may not purchase securities issued or underwritten by affiliates.

Loans to executive officers, directors or to any person who directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote more than 10% of any class of voting securities of a bank (a “10% Shareholder”), are subject to Sections 22(g) and 22(h) of the Federal Reserve Act and their corresponding regulations (Regulation O) and Section 13(k) of the Exchange Act relating to the prohibition on personal loans to executives (which exempts financial institutions in compliance with the insider lending restrictions of Section 22(h) of the Federal Reserve Act). Among other things, these loans must be made on terms substantially the same as those prevailing on transactions made to unaffiliated individuals and certain extensions of credit to those persons must first be approved in advance by a disinterested majority of the entire board of directors. Section 22(h) of the Federal Reserve Act prohibits loans to any of those individuals where the aggregate amount exceeds an amount equal to 15% of an institution’s unimpaired capital and surplus plus an additional 10% of unimpaired capital and surplus in the case of loans that are fully secured by readily marketable collateral, or when the aggregate amount on all of the extensions of credit outstanding to all of these persons would exceed the Bank’s unimpaired capital and unimpaired surplus. Section 22(g) of the Federal Reserve Act identifies limited circumstances in which the Bank is permitted to extend credit to executive officers.

Prompt Corrective Action. Immediately upon becoming “undercapitalized,” a depository institution becomes subject to the provisions of Section 38 of the FDIA, which: (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to

restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution's assets; and (v) require prior

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approval of certain expansion proposals. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the DIF, subject in certain cases to specified procedures. These discretionary supervisory actions include: (i) requiring the institution to raise additional capital; (ii) restricting transactions with affiliates; (iii) requiring divestiture of the institution or the sale of the institution to a willing purchaser; and (iv) any other supervisory action that the agency deems appropriate. These and additional mandatory and permissive supervisory actions may be taken with respect to significantly undercapitalized and critically undercapitalized institutions. The Bank met the definition of “well capitalized” as of December 31, 2016.

Community Reinvestment Act. The Bank is subject to the requirements of the Community Reinvestment Act of 1977. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of the local communities, including low and moderate income neighborhoods. If the Bank receives a rating from the Federal Reserve of less than satisfactory under the CRA, restrictions on operating activities could be imposed.

Privacy Legislation. Several recent regulations issued by federal banking agencies also provide new protections against the transfer and use of customer information by financial institutions. A financial institution must provide to its customers information regarding its policies and procedures with respect to the handling of customers’ personal information. Each institution must conduct an internal risk assessment of its ability to protect customer information. These privacy provisions generally prohibit a financial institution from providing a customer’s personal financial information to unaffiliated parties without prior notice and approval from the customer.

USA Patriot Act of 2001. In October 2001, the USA Patriot Act of 2001 (“Patriot Act”) was enacted in response to the September 11, 2001 terrorist attacks. The Patriot Act was intended to strengthen U. S. law enforcement and the intelligence communities’ abilities to work cohesively to combat terrorism. The continuing impact on financial institutions of the Patriot Act and related regulations and policies is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws, and imposes various regulations, including standards for verifying customer identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities to identify persons who may be involved in terrorism or money laundering.

Consumer Laws and Regulations. The Bank is also subject to certain consumer laws and regulations issued thereunder that are designed to protect consumers in transactions with banks. These laws include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Housing Act and the Dodd-Frank Act, among others. The laws and related regulations mandate certain disclosure requirements and regulate the manner in which financial institutions transact business with customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations.

Incentive Compensation. In June 2010, the federal banking agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of financial institutions do not undermine the safety and soundness of such institutions by encouraging excessive risk-taking. The *Interagency Guidance on Sound Incentive Compensation Policies*, which covers all employees that have the ability to materially affect the risk profile of a financial institution, either individually or as part of a group, is based upon the key principles that a financial institution’s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the institution’s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by good corporate governance, including active and effective oversight by the financial institution’s board of directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Company, that are not “large, complex banking organizations.” These reviews will be tailored to each financial institution based on the scope and complexity of the institution’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the institution’s supervisory ratings, which can affect the institution’s ability to make acquisitions and take other actions. Enforcement actions may be taken against a financial institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the institution’s safety and soundness and the financial institution is not taking prompt and effective measures to correct the deficiencies. At December 31, 2016, the Company had not been made aware of any instances of non-compliance with the guidance.

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Effect of Governmental Monetary Policies

The Company's operations are affected not only by general economic conditions but also by the policies of various regulatory authorities. In particular, the Federal Reserve regulates money and credit conditions and interest rates to influence general economic conditions. These policies have a significant impact on overall growth and distribution of loans, investments and deposits; they affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks, including the Company, in the past and are expected to do so in the future.

Item 1A. Risk Factors

An investment in the Company's securities involves risks. In addition to the other information set forth in this report, investors in the Company's securities should carefully consider the factors discussed below. These factors could materially and adversely affect the Company's business, financial condition, liquidity, results of operations and capital position, and could cause the Company's actual results to differ materially from its historical results or the results contemplated by the forward-looking statements contained in this report, in which case the trading price of the Company's securities could decline.

Risks Related To The Company's Business

The Company's business may be adversely affected by conditions in the financial markets and economic conditions generally.

The community banking industry is directly affected by national, regional, and local economic conditions. The economies in the Company's market areas continued to show improvement during 2016. Management allocates significant resources to mitigate and respond to risks associated with the current economic conditions, however, such conditions cannot be predicted or controlled. Therefore, such conditions, including a reduction in federal government spending, a flatter yield curve, and extended low interest rates, could adversely affect the credit quality of the Company's loans, and/or the Company's results of operations and financial condition. The Company's financial performance is dependent on the business environment in the markets where the Company operates, in particular, the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services the Company offers. In addition, the Company holds securities which can be significantly affected by various factors including credit ratings assigned by third parties. An adverse credit rating in securities held by the Company could result in a reduction of the fair value of its securities portfolio and have an adverse impact on its financial condition. While general economic conditions in Virginia and the U.S. continued to improve in 2016, there can be no assurance that this improvement will continue.

The inability of the Company to successfully manage its growth or implement its growth strategy may adversely affect the Company's results of operations and financial conditions.

The Company may not be able to successfully implement its growth strategy if it is unable to expand market share in existing locations, identify attractive markets, locations, or opportunities to expand in the future. In addition, the ability to manage growth successfully depends on whether the Company can maintain adequate capital levels, maintain cost controls, effectively manage asset quality, and successfully integrate any expanded business divisions or acquired businesses into the organization.

As the Company continues to implement its growth strategy by opening new branches or acquiring branches or banks, it expects to incur increased personnel, occupancy, and other operating expenses. In the case of new branches, the Company must absorb those higher expenses while it begins to generate new deposits. In the case of acquired branches, the Company must absorb higher expenses while it begins deploying the newly assumed deposit liabilities. With either new branches opened or branches acquired, there would be a time lag involved in deploying new deposits into attractively priced loans and other higher yielding earning assets. Thus, the Company's plans to expand could depress earnings in the short run, even if it efficiently executes a branching strategy leading to long-term financial benefits.

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Difficulties in combining the operations of acquired bank branches or entities with the Company's own operations may prevent the Company from achieving the expected benefits from acquisitions.

The Company may not be able to achieve fully the strategic objectives and operating efficiencies expected in an acquisition. Inherent uncertainties exist in integrating the operations of an acquired entity or acquired branches. In addition, the markets and industries in which the Company and its potential acquisition targets operate are highly competitive. The Company may lose customers or the customers of acquired entities as a result of an acquisition; the Company may lose key personnel, either from the acquired entity or from itself; and the Company may not be able to control the incremental increase in noninterest expense arising from an acquisition in a manner that improves its overall operating efficiencies. These factors could contribute to the Company's not achieving the expected benefits from its acquisitions within desired time frames, if at all. Future business acquisitions could be material to the Company and it may issue additional shares of common stock to support those acquisitions, which would dilute current shareholders' ownership interests. Acquisitions could also require the Company to use substantial cash or other liquid assets or to incur debt; the Company could therefore become more susceptible to economic downturns and competitive pressures.

The Company faces substantial competition that could adversely affect the Company's growth and/or operating results.

The Company operates in a competitive market for financial services and faces intense competition from other businesses both in making loans and attracting deposits which can greatly affect pricing for its products and services. The Company's primary competitors include community, regional, and national banks as well as credit unions and mortgage companies. Many of these financial institutions have been in business for many years, are significantly larger, have established customer bases and have greater financial resources and higher lending limits. In addition, credit unions are exempt from corporate income taxes, providing a significant competitive pricing advantage. Accordingly, some of the Company's competitors in its market have the ability to offer products and services that it is unable to offer or to offer at more competitive rates.

Consumers may increasingly decide not to use the Bank to complete their financial transactions, which would have a material adverse impact on the Company's financial condition and operations.

Technology and other changes are allowing parties to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts, mutual funds or general-purpose reloadable prepaid cards. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

The carrying value of intangible assets, such as goodwill and core deposit intangibles, may be adversely affected.

When a Company completes an acquisition, intangibles, such as goodwill and core deposit intangibles, are recorded on the date of acquisition as an asset. Current accounting guidance requires an evaluation for impairment, and the Company would perform such impairment analysis at least annually. A significant adverse change in expected future cash flows, sustained adverse change in the Company's common stock, or a decline in core deposit balances could require the asset to become impaired. If impaired, the Company would incur a charge to earnings that could have a significant impact on the results of operations.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the performance of the Bank's fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Bank's fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

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The Company depends on the accuracy and completeness of information about clients and counterparties, and its financial condition could be adversely affected if it relies on misleading information.

In deciding whether to extend credit or to enter into other transactions with clients and counterparties, the Company may rely on information furnished to it by or on behalf of clients and counterparties, including financial statements and other financial information, which the Company does not independently verify. The Company also may rely on representations of clients and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to clients, the Company may assume that a customer's audited financial statements conform to U.S. generally accepted accounting principles (GAAP) and present fairly, in all material respects, the financial condition, results of operations, and cash flows of the customer. The Company's financial condition and results of operations could be negatively impacted to the extent it relies on financial statements that do not comply with GAAP or are materially misleading.

The Company's dependency on its management team and the unexpected loss of any of those personnel could adversely affect operations.

The Company has assembled an experienced management team and continues to build the depth of that team. Although management development plans are in place, the unexpected loss of key employees could have a material adverse effect on the Company's business and may result in lower revenues or greater expenses.

Failure to maintain effective systems of internal and disclosure controls could have a material adverse effect on the Company's results of operation and financial condition.

Effective internal and disclosure controls are necessary for the Company to provide reliable financial reports and effectively prevent fraud, and to operate successfully as a public company. If the Company cannot provide reliable financial reports or prevent fraud, its reputation and operating results would be harmed. As part of the Company's ongoing monitoring of internal controls, it may discover material weaknesses or significant deficiencies in its internal control that require remediation. A "material weakness" is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis.

The Company continually works on improving its internal controls. However, the Company cannot be certain that these measures will ensure that it implements and maintains adequate controls over its financial processes and reporting. Any failure to maintain effective controls or to timely implement any necessary improvement of the Company's internal and disclosure controls could, among other things, result in losses from fraud or error, harm the Company's reputation, or cause investors to lose confidence in the Company's reported financial information, all of which could have a material adverse effect on the Company's results of operation and financial condition.

The Company's risk-management framework may not be effective in mitigating risk and loss.

The Company maintains an enterprise risk management program that is designed to identify, quantify, monitor, report, and control the risks that it faces. These risks include: interest-rate, credit, liquidity, operations, reputation, compliance, and litigation. While the Company assesses and improves this program on an ongoing basis, there can be no assurance that its approach and framework for risk management and related controls will effectively mitigate all risk and limit losses in its business. If conditions or circumstances arise that expose flaws or gaps in the Company's risk-management program, or if its controls break down, the Company's results of operations and financial condition may be adversely affected.

Negative public opinion could damage our reputation and adversely impact liquidity and profitability.

As a financial institution, the Company's earnings, liquidity, and capital are subject to risks associated with negative public opinion of the Company and of the financial services industry as a whole. Negative public opinion could result from our actual or alleged conduct in any number of activities, including lending practices, the failure of any product or service sold by us to meet our clients' expectations or applicable regulatory requirements, corporate governance and acquisitions, or from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect our ability to keep, attract and/or retain customers and can expose us to litigation and regulatory action. Actual or alleged conduct by one of our businesses can result in negative public opinion about our other businesses. Negative public opinion could also affect our ability to borrow funds in the unsecured wholesale debt markets.

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Negative perception of the Company through social media may adversely affect the Company's reputation and business.

The Company's reputation is critical to the success of its business. The Company believes that its brand image has been well received by customers, reflecting the fact that the brand image, like the Company's business, is based in part on trust and confidence. The Company's reputation and brand image could be negatively affected by rapid and widespread distribution of publicity through social media channels. The Company's reputation could also be affected by the Company's association with clients affected negatively through social media distribution, or other third parties, or by circumstances outside of the Company's control. Negative publicity, whether true or untrue, could affect the Company's ability to attract or retain customers, or cause the Company to incur additional liabilities or costs, or result in additional regulatory scrutiny.

Changes in interest rates could adversely affect the Company's income and cash flows.

The Company's income and cash flows depend to a great extent on the difference between the interest rates earned on interest-earning assets, such as loans and investment securities, and the interest rates paid on interest-bearing liabilities, such as deposits and borrowings. These rates are highly sensitive to many factors beyond the Company's control, including general economic conditions and the policies of the Federal Reserve and other governmental and regulatory agencies. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the prepayment of loans, the purchase of investments, the generation of deposits, and the rates received on loans and investment securities and paid on deposits or other sources of funding. The impact of these changes may be magnified if the Company does not effectively manage the relative sensitivity of its assets and liabilities to changes in market interest rates. In addition, the Company's ability to reflect such interest rate changes in pricing its products is influenced by competitive pressures. Fluctuations in these areas may adversely affect the Company and its shareholders. The Bank is often at a competitive disadvantage in managing its costs of funds compared to the large regional or national banks that have access to the national and international capital markets.

The Company generally seeks to maintain a neutral position in terms of the volume of assets and liabilities that mature or re-price during any period so that it may reasonably maintain its net interest margin; however, interest rate fluctuations, loan prepayments, loan production, deposit flows, and competitive pressures are constantly changing and influence the ability to maintain a neutral position. Generally, the Company's earnings will be more sensitive to fluctuations in interest rates depending upon the variance in volume of assets and liabilities that mature and re-price in any period. The extent and duration of the sensitivity will depend on the cumulative variance over time, the velocity and direction of changes in interest rates, shape and slope of the yield curve, and whether the Company is more asset sensitive or liability sensitive. Accordingly, the Company may not be successful in maintaining a neutral position and, as a result, the Company's net interest margin may be affected.

Limited availability of financing or inability to raise capital could adversely impact the Company.

The amount, type, source, and cost of the Company's funding and capital directly impacts the ability to grow assets. The ability to raise funds through deposits, borrowings and other sources, or raise capital could become more difficult, more expensive, or altogether unavailable. A number of factors could make such financing more difficult, more expensive or unavailable including: the financial condition of the Company at any given time; rate disruptions in the capital markets; the reputation for soundness and security of the financial services industry as a whole; and, competition for funding from other banks or similar financial service companies, some of which could be substantially larger or be more favorably rated.

The soundness of other financial institutions could adversely affect the Company.

The Company's ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by the Company or by other institutions. Many of these transactions expose the Company to credit risk in the event of default of its counterparty or client. There is no assurance that any such losses would not materially and adversely affect the Company's results of operations.

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The Company's exposure to operational, technological, and organizational risk may adversely affect the Company.

Similar to other financial institutions, the Company is exposed to many types of operational and technological risk, including reputation, legal, and compliance risk. The Company's ability to grow and compete is dependent on its ability to build or acquire the necessary operational and technological infrastructure and to manage the cost of that infrastructure while it expands and integrates acquired businesses. Operational risk can manifest itself in many ways, such as errors related to failed or inadequate processes, faulty or disabled computer systems, occurrences of fraud by employees or persons outside of the Company, and exposure to external events. The Company is dependent on its operational infrastructure to help manage these risks. From time to time, it may need to change or upgrade its technology infrastructure. The Company may experience disruption, and it may face additional exposure to these risks during the course of making such changes. If the Company would acquire another financial institution or bank branch operations, it would face additional challenges when integrating different operational platforms. Such integration efforts may be more disruptive to the business and/or more costly than anticipated.

The Company and the Bank rely on other companies to provide key components of their business infrastructure.

Third parties provide key components of the Company's (and the Bank's) business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections, and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problem caused by these third parties, including poor performance of services, failure to provide services, disruptions in communication services provided by a vendor and failure to handle current or higher volumes, could adversely affect the Company's ability to deliver products and services to its customers and otherwise conduct its business, and may harm its reputation. Financial or operational difficulties of a third party vendor could also hurt the Company's operations if those difficulties affect the vendor's ability to serve the Company. Replacing these third party vendors could also create significant delay and expense. Accordingly, use of such third parties creates an unavoidable inherent risk to the Company's business operations.

The Company continually encounters technological change which could affect its ability to remain competitive.

The financial services industry is continually undergoing change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company continues to invest in technology and connectivity to automate functions previously performed manually, to facilitate the ability of customers to engage in financial transactions, and otherwise to enhance the customer experience with respect to its products and services. The Company's continued success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that satisfy customer demands and create efficiencies in its operations. A failure to maintain or enhance a competitive position with respect to technology, whether because of a failure to anticipate customer expectations or because the Company's technological developments fail to perform as desired or are not rolled out in a timely manner, may cause the Company to lose market share or incur additional expense.

The operational functions of business counterparties over which the Company may have limited or no control may experience disruptions that could adversely impact the Company.

Multiple major U.S. retailers have recently experienced data systems incursions reportedly resulting in the thefts of credit and debit card information, online account information, and other financial data of the retailers' customers. Retailer incursions affect cards issued and deposit accounts maintained by many banks, including the Bank. Although neither the Company's nor the Bank's systems are breached in retailer incursions, these events can cause the Bank to reissue a significant number of cards and take other costly steps to avoid significant theft loss to the Bank and its customers. In some cases, the Bank may be required to reimburse customers for the losses they incur. Other possible points of intrusion or disruption not within the Company's nor the Bank's control include internet service providers, electronic mail portal providers, social media portals, distant-server ("cloud") service providers, electronic data security providers, telecommunications companies, and smart phone manufacturers.

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The Company's operations may be adversely affected by cyber security risks.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance, and use of this information is critical to operations and the Company's business strategy. The Company has invested in accepted technologies, and continually reviews processes and practices that are designed to protect its networks, computers, and data from damage or unauthorized access. Despite these security measures, the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance, or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. A breach in security could result in legal claims, regulatory penalties, disruption in operations, and damage to the Company's reputation, which could adversely affect its business. Furthermore, as cyber threats continue to evolve and increase, the Company may be required to expend significant additional resources to modify or enhance its protective measures, or to investigate and remediate any identified information security vulnerabilities.

Nonperforming assets take significant time to resolve and adversely affect the Company's results of operations and financial condition.

The Company's nonperforming assets adversely affect its net income in various ways. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases loan administration costs. When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related loan to the then fair market value of the collateral less estimated selling costs, which may result in a loss. An increase in the level of nonperforming assets also increases the Company's risk profile and may affect the capital levels that the Company believes are appropriate in light of such risks. The Company utilizes various techniques such as workouts, restructurings, and loan sales to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect the Company's business, results of operations, and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including origination of new loans. There can be no assurance that the Company will avoid further increases in nonperforming loans in the future.

The Bank's allowance for loan losses may prove to be insufficient to absorb losses in its loan portfolio.

Like all financial institutions, the Bank maintains an allowance for loan losses to provide for loans that its borrowers may not repay in their entirety. The Bank believes that it maintains an allowance for loan losses at a level adequate to absorb probable losses inherent in the loan portfolio as of the corresponding balance sheet date and in compliance with applicable accounting and regulatory guidance. However, the allowance for loan losses may not be sufficient to cover actual loan losses and future provisions for loan losses could materially and adversely affect the Company's operating results. Accounting measurements related to impairment and the allowance for loan losses require significant estimates that are subject to uncertainty and changes relating to new information and changing circumstances. The significant uncertainties surrounding the ability of the Bank's borrowers to execute their business models successfully through changing economic environments, competitive challenges, and other factors complicate the Bank's estimates of the risk of loss and amount of loss on any loan. Because of the degree of uncertainty and susceptibility of these factors to change, the actual losses may vary from current estimates. The Company expects fluctuations in the loan loss provisions due to the uncertain economic conditions.

The Company's banking regulators, as an integral part of their examination process, periodically review the allowance for loan losses and may require the Bank to increase its allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease the allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such required additional provisions for loan losses or charge-offs could have a material adverse effect on the Company's financial condition and results of operations.

If the Bank's valuation allowance on OREO becomes inadequate, results of operations may be adversely affected.

The Bank maintains a valuation allowance that it believes is a reasonable estimate of known losses in OREO. The Bank obtains appraisals on all OREO properties on an annual basis and adjusts the valuation allowance accordingly. The carrying value of OREO is susceptible to changes in economic and real estate market conditions. Although the Company believes the valuation allowance is a reasonable estimate of known losses, such losses and the adequacy of the allowance cannot be fully predicted. Excessive declines in market values could have a material impact on financial performance.

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The Bank's concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets.

The Bank offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer, and other loans. Many of the Bank's loans are secured by real estate (both residential and commercial) in the Bank's market areas. A major change in the real estate markets, resulting in deterioration in the value of this collateral, or in the local or national economy, could adversely affect borrowers' ability to pay these loans, which in turn could negatively affect the Bank. Risks of loan defaults and foreclosures are unavoidable in the banking industry; the Bank tries to limit its exposure to these risks by monitoring extensions of credit carefully. The Bank cannot fully eliminate credit risk; thus, credit losses will occur in the future. Additionally, changes in the real estate market also affect the value of foreclosed assets, and therefore, additional losses may occur when management determines it is appropriate to sell the assets.

The Bank has a concentration of credit exposure in commercial real estate, and loans with this type of collateral are viewed as having more risk of default.

The Bank's commercial real estate portfolio consists primarily of owner-operated properties and other commercial properties. These types of loans are generally viewed as having more risk of default than residential real estate loans. They are also typically larger than residential real estate loans and consumer loans and depend on cash flows from the owner's business or the property to service the debt. Cash flows may be affected significantly by general economic conditions, and a downturn in the local economy or in occupancy rates in the local economy where the property is located could increase the likelihood of default. Because the Bank's loan portfolio contains a number of commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in the percentage of non-performing loans. An increase in non-performing loans could result in a loss of earnings from these loans, an increase in the provision for loan losses and an increase in charge-offs, all of which could have a material adverse effect on the Bank's financial condition.

The Bank's banking regulators generally give commercial real estate lending greater scrutiny and may require banks with higher levels of commercial real estate loans to implement improved underwriting, internal controls, risk management policies, and portfolio stress testing, as well as possibly higher levels of allowances for losses and capital levels as a result of commercial real estate lending growth and exposures, which could have a material adverse effect on the Bank's results of operations.

The Bank's loan portfolio contains construction and development loans, and a decline in real estate values and economic conditions would adversely affect the value of the collateral securing the loans and have an adverse effect on the Bank's financial condition.

Although most of the Bank's construction and development loans are secured by real estate, the Bank believes that, in the case of the majority of these loans, the real estate collateral by itself may not be a sufficient source for repayment of the loan if real estate values decline. If the Bank is required to liquidate the collateral securing a construction and development loan to satisfy the debt, its earnings and capital may be adversely affected. A period of reduced real estate values may continue for some time, resulting in potential adverse effects on the Bank's earnings and capital.

The Company's credit standards and its on-going credit assessment processes might not protect it from significant credit losses.

The Company assumes credit risk by virtue of making loans and extending loan commitments and letters of credit. The Company manages credit risk through a program of underwriting standards, the review of certain credit decisions and a continuous quality assessment process of credit already extended. The Company's exposure to credit risk is managed through the use of consistent underwriting standards that emphasize local lending while avoiding highly leveraged transactions as well as excessive industry and other concentrations. The Company's credit administration function employs risk management techniques to help ensure that problem loans are promptly identified. While these procedures are designed to provide the Company with the information needed to implement policy adjustments where necessary and to take appropriate corrective actions, there can be no assurance that such measures will be effective in avoiding undue credit risk.

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The Company's focus on lending to small to mid-sized community-based businesses may increase its credit risk.

Most of the Company's commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company's results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle. Any deterioration of the borrowers' businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company's financial condition and results of operations.

The Bank relies upon independent appraisals to determine the value of the real estate which secures a significant portion of its loans, and the values indicated by such appraisals may not be realizable if the Bank is forced to foreclose upon such loans.

A significant portion of the Bank's loan portfolio consists of loans secured by real estate. The Bank relies upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment that adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of the Bank's loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, the Bank may not be able to recover the outstanding balance of the loan.

The Dodd-Frank Act substantially changes the regulation of the financial services industry and it could have a material adverse effect upon the Company.

The Dodd-Frank Act provides wide-ranging changes in the way banks and financial services firms generally are regulated and affect the way the Company and its customers and counterparties do business with each other. Among other things, it requires increased capital and regulatory oversight for banks and their holding companies, changes the deposit insurance assessment system, changes responsibilities among regulators, establishes the CFPB, and makes various changes in the securities laws and corporate governance that affect public companies, including the Company. The Dodd-Frank Act also requires numerous studies and regulations related to its implementation. The Company is continually evaluating the effects of the Dodd-Frank Act, together with implementing the regulations that have been proposed and adopted. The ultimate effects of the Dodd-Frank Act and the resulting rulemaking cannot be predicted at this time, but it has increased the Company's operating and compliance costs in the short-term, and it could have a material adverse effect on the Company's results of operation and financial condition.

The Bank is subject to more stringent capital and liquidity requirements as a result of the Basel III regulatory capital reforms and the Dodd-Frank Act, the short-term and long-term impact of which is uncertain.

The Bank is subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which each must maintain. From time to time, regulators implement changes to these regulatory capital adequacy guidelines. Under the Dodd-Frank Act, the federal banking agencies have established stricter capital requirements and leverage limits for banks and bank holding companies that are based on the Basel III regulatory capital reforms. These stricter capital requirements are being phased-in over a four-year period, which began on January 1, 2015, until they are fully-implemented on January 1, 2019. The application of these more stringent capital requirements could, among other things, result in lower returns on equity, require the raising of additional capital and adversely affect future growth opportunities. In addition, if the Bank fails to meet these minimum capital guidelines and/or other regulatory requirements, the Company's financial condition could be materially and adversely affected.

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Current and proposed regulation addressing consumer privacy and data use and security could increase the Company's costs and impact its reputation.

The Company is subject to a number of laws concerning consumer privacy and data use and securities, including information safeguard rules under the Gramm-Leach-Bliley Act. These rules require that financial institutions develop, implement, and maintain a written, comprehensive information security program containing safeguards that are appropriate to the financial institution's size and complexity, the nature and scope of the financial institution's activities, and the sensitivity of any customer information at issue. The United States has experienced a heightened legislative and regulatory focus on privacy and data security, including requiring consumer notification in the event of a data breach. In addition, most states have enacted security breach legislation requiring varying levels of consumer notification in the event of certain types of security breaches. New regulations in these areas may increase compliance costs, which could negatively impact earnings. In addition, failure to comply with the privacy and data use and security laws and regulations to which the Company is subject, including by reason of inadvertent disclosure of confidential information, could result in fines, sanctions, penalties, or other adverse consequences and loss of consumer confidence, which could materially adversely affect our results of operations, overall business, and reputation.

Legislative or regulatory changes or actions, or significant litigation, could adversely affect the Company or the businesses in which the Company is engaged.

The Company is subject to extensive state and federal regulation, supervision, and legislation that govern almost all aspects of its operations. Laws and regulations change from time to time and are primarily intended for the protection of consumers, depositors, and the FDIC's DIF. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively affect the Company or its ability to increase the value of its business. Such changes include higher capital requirements, and could include increased insurance premiums, increased compliance costs, reductions of noninterest income, and limitations on services that can be provided. Actions by regulatory agencies or significant litigation against the Company could cause it to devote significant time and resources to defend itself and may lead to liability or penalties that materially affect the Company and its shareholders. Future changes in the laws or regulations or their interpretations or enforcement could be materially adverse to the Company and its shareholders.

See the section of this report entitled "Supervision and Regulation" for additional information on the statutory and regulatory issues that affect the Company's business.

Changes in accounting standards could impact reported earnings and capital.

The authorities that promulgate accounting standards, including the Financial Accounting Standards Board (the FASB), the United States Securities Exchange Commission (the SEC), and other regulatory authorities, periodically change the financial accounting and reporting standards that govern the preparation of the Company's consolidated financial statements. These changes are difficult to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of financial statements for prior periods. Such changes could also impact the capital levels of the Company and the Bank, or require the Company to incur additional personnel or technology costs. Most notably, new guidance on the calculation of credit reserves using current expected credit losses was finalized in June, 2016. The standard will be effective for the Company beginning January 1, 2020. To implement the new standard, the Company will incur costs related to data collection and documentation, technology, and training. Implementation of the new standard could impact the required credit reserves, reported earnings, and capital levels of the Company and the Bank.

Changes in tax rates applicable to the Company may cause impairment of deferred tax assets.

The Company determines deferred income taxes using the balance sheet method. Under this method, each asset and liability is examined to determine the difference between its book basis and its tax basis. The difference between the book basis and the tax basis of each asset and liability is multiplied by the Company's marginal tax rate to determine the net deferred tax asset or liability. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods.

The marginal tax rate applicable to the Company, as with all entities subject to federal income tax, is based on the Company's taxable income. If the Company's taxable income declines such that the Company's marginal tax rate declines, the change in deferred income tax assets and liabilities would result in an expense during the period that a lower marginal tax rate occurs. If changes in tax rates and laws are enacted, the company will recognize the changes in the period in which they occur. Changes in tax rates and laws could impair the Company's deferred tax assets and result in an expense associated with the change in deferred tax assets and liabilities.

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Risks Related To The Company's Securities

The Company's ability to pay dividends depends upon the results of operations of its Bank subsidiary.

The Company is a bank holding company that conducts substantially all of its operations through its subsidiary Bank. As a result, the Company's ability to make dividend payments on its common stock depends primarily on certain federal regulatory considerations and the receipt of dividends and other distributions from the Bank. There are various regulatory restrictions on the ability of the Bank to pay dividends or make other payments to the Company. Although the Company has historically paid a cash dividend to the holders of its common stock, holders of the common stock are not entitled to receive dividends, and regulatory or economic factors may cause the Company's Board of Directors to consider, among other things, the reduction of dividends paid on the Company's common stock.

There is a limited trading market for the Company's common stock; it may be difficult to sell shares.

The trading volume in the Company's common stock has been relatively limited. Even if a more active market develops, there can be no assurance that a more active and liquid trading market for the common stock will exist in the future. Consequently, shareholders may not be able to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares. In addition, the Company cannot predict the effect, if any, that future sales of its common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock. Sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, could cause the price of the Company's common stock to decline, or reduce the Company's ability to raise capital through future sales of common stock. The lack of liquidity of the investment in the common shares should be carefully considered when making an investment decision.

Future issuances of the Company's common stock could adversely affect the market price of the common stock and could be dilutive.

The Company is not restricted from issuing additional authorized shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, shares of common stock. Issuances of a substantial number of shares of common stock, or the expectation that such issuances might occur, including in connection with acquisitions by the Company, could materially adversely affect the market price of the shares of common stock and could be dilutive to shareholders. Because the Company's decision to issue common stock in the future will depend on market conditions and other factors, it cannot predict or estimate the amount, timing, or nature of possible future issuances of its common stock. Accordingly, the Company's shareholders bear the risk that future issuances will reduce the market price of the common stock and dilute their stock holdings in the Company.

The current economic conditions may cause volatility in the Company's common stock value.

The value of publicly traded stocks in the financial services sector can be volatile. The value of the Company's common stock can also be affected by a variety of factors such as expected results of operations, actual results of operations, actions taken by shareholders, news or expectations based on the performance of others in the financial services industry, and expected impacts of a changing regulatory environment. These factors not only impact the value of the Company's common stock but could also affect the liquidity of the stock given the Company's size, geographical footprint, and industry.

The Company's subordinated debt and junior subordinated debt are superior to our common stock, which may limit our ability to pay dividends on common stock in the future.

Our ability to pay dividends on common stock is also limited by contractual restrictions under our subordinated debt and junior subordinated debt. Interest must be paid on the subordinated debt and junior subordinated debt before dividends may be paid to common shareholders. The Company is current in its interest payments on subordinated debt and junior subordinated debt; however, it has the right to defer distributions on its junior subordinated debt, during which time no dividends may be paid on its common stock. If the Company does not have sufficient earnings in the future and begins to defer distributions on the junior subordinated debt, it will be unable to pay dividends on its common stock until it becomes current on those distributions.

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The Company's governing documents and Virginia law contain anti-takeover provisions that could negatively affect its shareholders.

The Company's Articles of Incorporation and the Virginia Stock Corporation Act contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the Company. These provisions and the ability to set the voting rights, preferences, and other terms of any series of outstanding preferred stock and preferred stock that may be issued, may be deemed to have an anti-takeover effect and may discourage takeovers (which certain shareholders may deem to be in their best interest). To the extent that such takeover attempts are discouraged, temporary fluctuations in the market price of the Company's common stock resulting from actual or rumored takeover attempts may be inhibited. These provisions also could discourage or make more difficult a merger, tender offer, or proxy contest, even though such transactions may be favorable to the interests of shareholders, and could potentially adversely affect the market price of the Company's common stock.

The Company may deregister under the Exchange Act, which would result in a reduction in the amount and frequency of publicly-available information about the Company.

The Jumpstart Our Business Startups Act (the JOBS Act) may allow the Company to terminate the registration of its common stock under the Exchange Act. If the Company determines to deregister its common stock under the Exchange Act, it would enable it to save significant expenses relating to its public disclosure and reporting requirements under the Exchange Act. However, a de-registration of common stock also would result in a reduction in the amount and frequency of publicly-available information about the Company and the Bank.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

The Company, through its primary operating subsidiary, First Bank, owns or leases buildings that are used in the normal course of business. The Company's headquarters is located at 112 West King Street, Strasburg, Virginia. The Bank owns or leases various other offices in the counties and cities in which it operates. At December 31, 2016, the Bank operated 14 branches throughout the Shenandoah Valley and the central Virginia regions. The Bank also operated two loan production offices in the Shenandoah Valley region of Virginia, as well as a customer service center in a retirement community. The Company's operations center is in Strasburg, Virginia. All of the Company's properties are in good operating condition and are adequate for the Company's present and future needs. See Note 1 "Summary of Significant Accounting Policies," Note 6, "Premises and Equipment" and Note 17, Lease Commitments in the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K for information with respect to the amounts at which Bank premises and equipment are carried and commitments under long-term leases.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or to which the property of the Company is subject.

Item 4. Mine Safety Disclosures

None.

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Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Prices and Dividends

Shares of the common stock of the Company are traded on the over-the-counter (OTC) market and quoted on the OTC Markets Group exchange under the symbol "FXNC." As of March 17, 2017 the Company had 580 shareholders of record and approximately 584 additional beneficial owners of shares of common stock.

Following are the high and low prices of sales of common stock known to the Company, along with the dividends that were paid quarterly in 2015 and 2016 (per share).

	Market Prices and Dividends		
	Sales Price (\$)		Dividends (\$)
	High	Low	
2015:			
1st quarter	9.95	8.50	0.025
2nd quarter	9.95	9.26	0.025
3rd quarter	9.50	8.30	0.025
4th quarter	8.95	7.92	0.025
2016:			
1st quarter	9.10	8.70	0.03
2nd quarter	9.75	8.84	0.03
3rd quarter	11.14	9.50	0.03
4th quarter	13.13	10.65	0.03

Dividend Policy

A discussion of certain limitations on the ability of the Bank to pay dividends to the Company and the ability of the Company to pay dividends on its common stock, is set forth in Part I., Item 1—Business, of this Form 10-K under the headings "Supervision and Regulation - Limits on Dividends and Other Payments" and Item 1A—Risk Factors, "The Company's subordinated debt and junior subordinated debt are superior to our common stock, which may limit our ability to pay dividends on common stock in the future."

The Company's future dividend policy is subject to the discretion of its Board of Directors and will depend upon a number of factors, including future earnings, financial condition, liquidity and capital requirements of both the Company and the Bank, applicable governmental regulations and policies and other factors deemed relevant by the Board of Directors.

Stock Repurchases

The Company did not repurchase any shares of its common stock during 2016.

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Item 6. Selected Financial Data

The following is selected financial data for the Company for the last five years. This information has been derived from audited financial information included in Item 8 of this Form 10-K (in thousands, except ratios and per share amounts).

	As of and for the years ended December 31,										
	2016		2015		2014		2013		2012		
Results of Operations											
Interest and dividend income	\$	25,237	\$	22,165	\$	20,399	\$	21,157	\$	23,432	
Interest expense		1,982		1,441		1,778		2,709		4,167	
Net interest income		23,255		20,724		18,621		18,448		19,265	
Provision for (recovery of) loan losses		—		(100)		(3,850)		(425)		3,555	
Net interest income after provision for (recovery of) loan losses		23,255		20,824		22,471		18,873		15,710	
Noninterest income		8,493		8,342		7,444		6,931		7,172	
Noninterest expense		23,488		25,555		18,785		20,750		19,117	
Income before income taxes		8,260		3,611		11,130		5,054		3,765	
Income tax expense (benefit)		2,353		956		3,499		(4,820)		965	
Net income		5,907		2,655		7,631		9,874		2,800	
Effective dividend and accretion on preferred stock		—		1,113		1,138		913		904	
Net income available to common shareholders	\$	5,907	\$	1,542	\$	6,493	\$	8,961	\$	1,896	
Key Performance Ratios											
Return on average assets		0.84	%	0.41	%	1.45	%	1.85	%	0.53	%
Return on average equity		12.00	%	4.58	%	13.49	%	21.87	%	6.80	%
Net interest margin		3.61	%	3.52	%	3.86	%	3.72	%	3.89	%
Efficiency ratio(1)		71.05	%	80.92	%	73.96	%	74.79	%	70.01	%
Dividend payout		10.01	%	31.84	%	5.67	%	0.00	%	0.00	%
Equity to assets		7.28	%	6.64	%	11.50	%	10.24	%	8.43	%
Per Common Share Data											
Net income (loss), basic	\$	1.20		\$	0.31		\$	1.32		\$	0.48
Net income (loss), diluted		1.20		0.31		1.32		1.83		0.48	
Cash dividends		0.12		0.10		0.075		0.00		0.00	
Book value at period end		10.58		9.35		9.17		7.96		6.22	
Financial Condition											
Assets	\$	716,000	\$	692,321	\$	518,165	\$	522,890	\$	532,697	
Loans, net		480,746		433,475		371,692		346,449		370,519	
Securities		149,748		173,469		84,658		105,105		91,430	
Deposits		645,570		627,116		444,338		450,711		466,917	
Shareholders' equity		52,151		45,953		59,564		53,560		44,889	
Average shares outstanding, diluted		4,928		4,913		4,902		4,901		3,945	
Capital Ratios(2)											
Leverage		8.48	%	8.12	%	12.90	%	10.68	%	9.15	%
Risk-based capital ratios:											
Common equity Tier 1 capital		12.38	%	12.62	%	N/A		N/A		N/A	
Tier 1 capital		12.38	%	12.62	%	17.88	%	15.35	%	12.31	%
Total capital		13.47	%	13.86	%	19.14	%	16.62	%	13.59	%

The efficiency ratio is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes

- (1) such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under generally accepted accounting principles, or "GAAP." See "Non-GAAP Financial Measures" included in Item 7 of this Form 10-K.
- (2) All capital ratios reported are for the Bank.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis of the financial condition and results of operations of the Company for the years ended December 31, 2016 and 2015 should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements included in Item 8 of this Form 10-K.

Executive Overview

The Company

First National Corporation (the Company) is the bank holding company of:

- First Bank (the Bank). The Bank owns:
- First Bank Financial Services, Inc.
- Shen-Valley Land Holdings, LLC
- First National (VA) Statutory Trust II (Trust II)
- First National (VA) Statutory Trust III (Trust III)

First Bank Financial Services, Inc. invests in entities that provide title insurance and investment services. Shen-Valley Land Holdings, LLC was formed to hold other real estate owned and future office sites. The Trusts were formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities and are not included in the Company's consolidated financial statements in accordance with authoritative accounting guidance because management has determined that the Trusts qualify as variable interest entities.

Products, Services, Customers and Locations

The Bank provides loan, deposit, wealth management and other products and services in the Shenandoah Valley and central regions of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, money market accounts, individual retirement accounts, certificates of deposit and cash management accounts.

The Bank's wealth management department offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. The Bank's mortgage department originates residential mortgage loans to customers. Loans originated through this department may be sold to investors in the secondary market or held in the Bank's loan portfolio. Mortgage services are offered to customers throughout the Bank's market area.

The Bank's office locations are well-positioned in attractive markets along the Interstate 81, Interstate 66 and Interstate 64 corridors in the Shenandoah Valley and central regions of Virginia. Within this market area, there are various types of industry including medical and professional services, manufacturing, retail, government contracting and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

The Bank's products and services are delivered through its mobile banking platform, its website, www.fbvirginia.com, a network of ATMs located throughout its market area, two loan production offices, a customer service center in a retirement village, and 14 bank branch office locations located throughout the Shenandoah Valley and central regions of Virginia. The branch offices are comprised of 13 full service retail banking offices and one drive-thru express banking office. For the location and general character of each of these offices, see Item 2 of this Form 10-K.

Revenue Sources and Expense Factors

The primary source of revenue is from net interest income earned by the Bank. Net interest income is the difference between interest income and interest expense and typically represents between 70% and 80% of the Company's total revenue. Interest income is determined by the amount of interest-earning assets outstanding during the period and the interest rates earned on those assets. The Bank's interest expense is a function of the amount of interest-bearing liabilities outstanding during the period and the interest rates paid. In addition to net interest income, noninterest income is the other source of revenue for the Company. Noninterest income is derived primarily from service charges on deposits, fee income from wealth management services and ATM and check card fees.

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Primary expense categories are salaries and employee benefits, which comprised 55% of noninterest expenses during 2016, followed by occupancy and equipment expense, which comprised 13% of noninterest expenses. Historically, the provision for loan losses has also been a primary expense of the Bank. The provision is determined by factors that include net charge-offs, asset quality, economic conditions and loan growth. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses.

Financial Performance and Condition

Net income available to common shareholders increased by \$4.4 million to \$5.9 million, or \$1.20 per basic and diluted share, for the year ended December 31, 2016, compared to \$1.5 million, or \$0.31 per basic and diluted share, for the same period in 2015. Return on average assets was 0.84% and return on average equity was 12.00% for the year ended December 31, 2016, compared to 0.41% and 4.58%, respectively, for the year ended December 31, 2015.

The \$4.4 million increase in net income available to common shareholders for the year ended December 31, 2016 resulted from a \$2.5 million, or 12%, increase in net interest income, a \$151 thousand, or 2%, increase in noninterest income, and a \$2.1 million, or 8%, decrease in noninterest expenses, compared to the same period of 2015. These improvements were partially offset by a \$100 thousand decrease in recovery of loan losses and a \$1.4 million increase in income tax expense. Net income available to common shareholders also increased due to a \$1.1 million decrease in the effective dividend on preferred stock, when comparing the periods.

Net interest income increased from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 10% and the net interest margin increased 3%, or 9 basis points, to 3.61% for the year ended December 31, 2016, compared to 3.52% for the same period in 2015. Noninterest expense decreased primarily from lower salaries and employee benefit expense, lower supplies expense, lower legal and professional fees, and lower net expenses related to other real estate owned. The decrease in the effective dividend and accretion on preferred stock resulted from the redemption of all outstanding preferred stock in the prior year. Based on management's analysis and the supporting allowance for loan loss calculation, a provision for (or recovery of) loan losses was not recorded during the year ended December 31, 2016, compared to a recovery of loan losses of \$100 thousand for the same period one year ago.

Debt Issuance and Preferred Stock Redemption

During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 pursuant to which the Company issued an interest only subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum with a maturity date of October 1, 2025. On November 6, 2015, the Company used the proceeds from the dividends and from the issuance of the Note to redeem all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A, totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B, totaling \$695 thousand.

Acquisition of Branches

On April 17, 2015, the Bank expanded its branch network in the Shenandoah Valley and central Virginia regions through the acquisition of six bank branches from Bank of America, National Association located in Woodstock, Staunton, Elkton, Waynesboro, Farmville and Dillwyn, Virginia (the Acquisition). The Acquisition included the purchase of \$4.5 million of premises and equipment and the assumption of \$186.8 million of deposit liabilities. No loans were purchased in the transaction. Upon completion of the Acquisition, the Bank hired all 36 of the employees working at the six acquired branches. During second quarter of 2015, the Bank also hired a regional president and appointed two market executives in the new markets. As a result of the transaction, the Bank increased the number of bank branch locations from 10 to 16, in addition to its existing loan production office in the city of Harrisonburg, Virginia, and its customer service center located in a retirement community in Winchester, Virginia.

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Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO income/(expense), amortization of intangibles, losses on disposal of premises and equipment, and acquisition and integration related expenses, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities (gains)/losses and bargain purchase gain. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the following table (dollars in thousands).

	Efficiency Ratio	
	<u>2016</u>	<u>2015</u>
Noninterest expense	\$ 23,488	\$ 25,555
Add/(Subtract): other real estate owned income/(expense), net	120	(352)
Subtract: amortization of intangibles	(771)	(642)
Subtract: losses on disposal of premises and equipment, net	(8)	—
Subtract: acquisition and integration related expenses	—	(908)
	<u>\$ 22,829</u>	<u>\$ 23,653</u>
Tax-equivalent net interest income	\$ 23,646	\$ 21,033
Noninterest income	8,493	8,342
Add/(Subtract): securities (gains)/losses, net	(8)	55
Subtract: bargain purchase gain	—	(201)
	<u>\$ 32,131</u>	<u>\$ 29,229</u>
Efficiency ratio	<u>71.05 %</u>	<u>80.92 %</u>

This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for both 2016 and 2015 is 34%. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below (in thousands).

	Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income	
	<u>2016</u>	<u>2015</u>
GAAP measures:		
Interest income - loans	\$ 21,662	\$ 19,138
Interest income - investments and other	3,575	3,027
Interest expense - deposits	(1,353)	(1,150)
Interest expense - other borrowings	(6)	(3)
Interest expense – subordinated debt	(361)	(62)
Interest expense – junior subordinated debt	(259)	(224)
Interest expense – federal funds purchased	(3)	(2)
Total net interest income	<u>\$ 23,255</u>	<u>\$ 20,724</u>
Non-GAAP measures:		
Tax benefit realized on non-taxable interest income - loans	\$ 101	\$ 105
Tax benefit realized on non-taxable interest income - municipal securities	290	204
Total tax benefit realized on non-taxable interest income	<u>\$ 391</u>	<u>\$ 309</u>
Total tax-equivalent net interest income	<u>\$ 23,646</u>	<u>\$ 21,033</u>

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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 losses 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.

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

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for (or recovery of) loan losses charged to earnings. Loan losses are charged against the allowance when management determines that the loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance. For further information about the Company's loans and the allowance for loan losses, see Notes 1, 3 and 4 in this Form 10-K.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company performs regular credit reviews of the loan portfolio to review credit quality and adherence to underwriting standards. The credit reviews consist of reviews by its internal credit administration department and reviews performed by an independent third party. Upon origination, each loan is assigned a risk rating ranging from one to nine, with loans closer to one having less risk. This risk rating scale is our primary credit quality indicator. The Company has various committees that review and ensure that the allowance for loans losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio.

The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of the collateral, overall portfolio quality and review of specific potential losses. The evaluation also considers the following risk characteristics of each loan portfolio class:

- 1-4 family residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

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

- Other real estate loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because repayment of these loans may be dependent upon the profitability and cash flows of the business or project.

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

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

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

The general component covers loans that are not considered impaired and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is calculated by loan type and uses an average loss rate during the preceding twelve quarters. The qualitative factors are assigned by management based on delinquencies and asset quality, national and local economic trends, effects of the changes in the value of underlying collateral, trends in volume and nature of loans, effects of changes in the lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan type. The general allowance estimates losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management's assessment of the above described factors and the relative weights given to each factor. For further information regarding the allowance for loan losses see Notes 1 and 4 to the Consolidated Financial Statements.

Other Real Estate Owned (OREO)

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

Business Combinations

Business combinations are accounted for under ASC 805, Business Combinations, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company relies on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. The determination of fair values requires management to make estimates about future cash flows, market conditions and other events, which are highly subjective in nature. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are incremental costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of acquisition-related costs to the Company include system conversions, integration planning consultants, and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received. The costs to issue debt or equity securities will be recognized in accordance with other applicable U.S. GAAP. These acquisition-related costs are included within the Consolidated Statements of Income classified within the noninterest expense caption.

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Pension Plan

The Company's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the estimated return on plan assets and the anticipated rate of compensation increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

Other-Than-Temporary Impairment of Securities

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either the Company (1) intends to sell the security or (2) it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more-than-likely that it will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity securities carried at cost, such as restricted securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income. The Company regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the Company's intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

Lending Policies

General

In an effort to manage risk, the Bank's loan policy gives loan amount approval limits to individual loan officers based on their position within the Bank and level of experience. The Management Loan Committee can approve new loans up to their authority. The Board Loan Committee approves all loans which exceed the authority of the Management Loan Committee. The full Board of Directors must approve loans which exceed the authority of the Board Loan Committee, up to the Bank's legal lending limit. The Board Loan Committee currently consists of four directors, three of which are non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews risk management reports, including watch list reports and concentrations of credit. The Board Loan Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

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

As part of the ongoing monitoring of the credit quality of the Company's loan portfolio, certain appraisals are analyzed by management or by an outsourced appraisal review specialist throughout the year in order to ensure standards of quality are met. The Company also obtains an independent review of loans within the portfolio on an annual basis to analyze loan risk ratings and validate specific reserves on impaired loans.

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are disclosed but not reflected in its financial statements, including commitments to extend credit. At December 31, 2016, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$90.5 million.

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Construction and Land Development Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated based on the completion of construction. Thus, there is risk associated with failure to complete construction and potential cost overruns. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, typically requires personal guarantees from the borrower's principal owners, and typically monitors the progress of the construction project during the draw period.

1-4 Family Residential Real Estate Lending

1-4 family residential lending activity may be generated by Bank loan officer solicitations and referrals by real estate professionals and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. Residential mortgage loans generally are made on the basis of the borrower's ability to make payments from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank's underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. The valuation of residential collateral is generally provided by independent fee appraisers who have been approved by the Board Loan Committee. In addition to originating fixed rate mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank originates balloon and other mortgage loans for the portfolio. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

Commercial Real Estate Lending

Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. Commercial real estate loan originations are obtained through direct solicitation of customers and potential customers. The valuation of commercial real estate collateral is provided by independent appraisers who have been approved by the Board Loan Committee. Commercial real estate lending entails significant additional risk, compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the payment experience on loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios, the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers' principal owners and considers the valuation of the real estate collateral.

Commercial and Industrial Lending

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

Personal Lending

Loans to individual borrowers may be secured or unsecured, and include unsecured personal loans and lines of credit, automobile loans, deposit account loans and installment and demand loans. These personal loans may entail greater risk than residential mortgage loans, particularly in the case of personal 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 personal 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. Personal loan collections are dependent on the borrower's continuing financial stability, and thus are

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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 personal 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, subordinated debt and junior subordinated debt. 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 (recovery of) 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, revenue from wealth management services, ATM and check card income, revenue from other customer services, income from bank owned life insurance, general and administrative expenses, amortization expense, and other real estate owned income or expense.

Net Interest Income

Net interest income increased \$2.5 million, or 12%, to \$23.3 million for the year ended December 31, 2016, compared to \$20.7 million for the prior year. The increase resulted primarily from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 10%, and the net interest margin increased 3%, or 9 basis points, to 3.61% for the year ended December 31, 2016, compared to 3.52% for the same period in 2015. The 9 basis point increase in the net interest margin resulted from a 15 basis point increase in the yield on total earning assets, which was partially offset by a 6 basis point increase in interest expense as a percent of average earning assets.

The higher yield on earning assets was attributable to the change in the composition of earning assets, as average loan balances increased to 71% of average earning assets for the year ended December 31, 2016, compared to 67% of average earning assets for the same period in 2015. Interest-bearing deposits with other institutions decreased as a percentage of average earning assets, comparing the same periods. The change in the earning asset composition had a favorable impact on the total earning asset yield as loan rates were greater than rates earned on interest-bearing deposits with other institutions. The increase in interest expense as a percent of average earning assets was primarily attributable to the issuance of subordinated debt in the fourth quarter of 2015 and the impact of holding the subordinated debt for the full year of 2016.

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The following table provides information on average interest-earning assets and interest-bearing liabilities for the years ended December 31, 2016, 2015 and 2014, as well as amounts and rates of tax equivalent interest earned and interest paid (dollars in thousands). The volume and rate analysis table analyzes the changes in net interest income for the periods broken down by their rate and volume components (in thousands).

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

	Years Ending December 31,								
	2016			2015			2014		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets									
Interest-bearing deposits in other banks	\$ 35,812	\$ 238	0.66 %	\$ 64,395	\$ 197	0.31 %	\$ 16,718	\$ 38	0.22 %
Securities:									
Taxable	131,805	2,692	2.04 %	116,441	2,358	2.03 %	94,689	2,144	2.26 %
Tax-exempt (1)	24,054	854	3.55 %	16,412	599	3.65 %	11,963	542	4.53 %
Restricted	1,564	81	5.17 %	1,435	77	5.39 %	1,667	82	4.94 %
Total securities	<u>157,423</u>	<u>3,627</u>	2.30 %	<u>134,288</u>	<u>3,034</u>	2.26 %	<u>108,319</u>	<u>2,768</u>	2.56 %
Loans: (2)									
Taxable	455,847	21,467	4.71 %	391,963	18,934	4.83 %	358,259	17,568	4.90 %
Tax-exempt (1)	6,828	296	4.33 %	7,116	309	4.34 %	7,176	317	4.41 %
Total loans	<u>462,675</u>	<u>21,763</u>	4.70 %	<u>399,079</u>	<u>19,243</u>	4.82 %	<u>365,435</u>	<u>17,885</u>	4.89 %
Federal funds sold	3	—	0.52 %	1	—	0.21 %	—	—	—
Total earning assets	<u>655,913</u>	<u>25,628</u>	3.91 %	<u>597,763</u>	<u>22,474</u>	3.76 %	<u>490,472</u>	<u>20,691</u>	4.22 %
Less: allowance for loan losses	(5,577)			(6,270)			(10,208)		
Total nonearning assets	<u>54,936</u>			<u>51,485</u>			<u>44,764</u>		
Total assets	<u><u>\$ 705,272</u></u>			<u><u>\$ 642,978</u></u>			<u><u>\$ 525,028</u></u>		
Liabilities and Shareholders' Equity									
Interest-bearing deposits:									
Checking	\$ 150,412	\$ 392	0.26 %	\$ 135,976	\$ 195	0.14 %	\$ 112,972	\$ 172	0.15 %
Money market accounts	61,086	105	0.17 %	46,161	59	0.13 %	19,155	21	0.11 %
Savings accounts	126,434	105	0.08 %	114,632	96	0.08 %	101,793	89	0.09 %
Certificates of deposit:									
Less than \$100	87,828	382	0.44 %	83,280	326	0.39 %	62,623	540	0.86 %
Greater than \$100	45,925	366	0.80 %	49,511	470	0.95 %	47,963	592	1.23 %
Brokered deposits	600	3	0.45 %	767	4	0.50 %	4,756	28	0.59 %
Total interest-bearing deposits	<u>472,285</u>	<u>1,353</u>	0.29 %	<u>430,327</u>	<u>1,150</u>	0.27 %	<u>349,262</u>	<u>1,442</u>	0.41 %
Federal funds purchased	336	3	1.03 %	213	2	0.72 %	357	3	0.87 %
Subordinated debt	4,921	361	7.33 %	855	62	7.26 %	—	—	—
Junior subordinated debt	9,279	259	2.79 %	9,279	224	2.41 %	9,279	218	2.35 %
Other borrowings	1,235	6	0.49 %	1,211	3	0.28 %	5,891	115	1.95 %
Total interest-bearing liabilities	<u>488,056</u>	<u>1,982</u>	0.41 %	<u>441,885</u>	<u>1,441</u>	0.33 %	<u>364,789</u>	<u>1,778</u>	0.49 %
Noninterest-bearing liabilities									
Demand deposits	161,882			138,193			101,209		
Other liabilities	6,110			4,972			2,451		
Total liabilities	<u>656,048</u>			<u>585,050</u>			<u>468,449</u>		

Shareholders' equity	<u>49,224</u>		<u>57,928</u>		<u>56,579</u>
Total liabilities and shareholders' equity	\$ 705,272		\$ 642,978		\$ 525,028
Net interest income	<u><u>\$ 23,646</u></u>		<u><u>\$ 21,033</u></u>		<u><u>\$ 18,913</u></u>
Interest rate spread		3.50 %		3.43 %	3.73 %
Cost of funds		0.30 %		0.25 %	0.38 %
Interest expense as a percent of average earning assets		0.30 %		0.24 %	0.36 %
Net interest margin		3.61 %		3.52 %	3.86 %

Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The (1) tax-equivalent adjustment was \$391 thousand, \$309 thousand and \$292 thousand for 2016, 2015 and 2014, respectively.

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

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	Volume and Rate					
	Years Ending December 31,					
	2016			2015		
	Volume Effect	Rate Effect	Change in Income/Expense	Volume Effect	Rate Effect	Change in Income/Expense
Interest-bearing deposits in other banks	\$(27)	\$68	\$ 41	\$ 139	\$20	\$ 159
Loans, taxable	2,989	(456)	2,533	1,610	(244)	1,366
Loans, tax-exempt	(12)	(1)	(13)	(3)	(5)	(8)
Securities, taxable	322	12	334	384	(170)	214
Securities, tax-exempt	271	(16)	255	118	(61)	57
Securities, restricted	7	(3)	4	(14)	9	(5)
Federal funds sold	—	—	—	—	—	—
Total earning assets	<u>\$3,550</u>	<u>\$(396)</u>	<u>\$ 3,154</u>	<u>\$2,234</u>	<u>\$(451)</u>	<u>\$ 1,783</u>
Checking	\$22	\$175	\$ 197	\$34	\$(11)	\$ 23
Money market accounts	24	22	46	34	4	38
Savings accounts	9	—	9	54	(47)	7
Certificates of deposits:						
Less than \$100	17	39	56	324	(538)	(214)
Greater than \$100	(33)	(71)	(104)	20	(142)	(122)
Brokered deposits	(1)	—	(1)	(20)	(4)	(24)
Federal funds purchased	1	—	1	(1)	—	(1)
Subordinated debt	298	1	299	62	—	62
Junior subordinated debt	—	35	35	—	6	6
Other borrowings	—	3	3	(54)	(58)	(112)
Total interest-bearing liabilities	<u>\$337</u>	<u>\$204</u>	<u>\$ 541</u>	<u>\$453</u>	<u>\$(790)</u>	<u>\$ (337)</u>
Change in net interest income	<u><u>\$3,213</u></u>	<u><u>\$(600)</u></u>	<u><u>\$ 2,613</u></u>	<u><u>\$ 1,781</u></u>	<u><u>\$339</u></u>	<u><u>\$ 2,120</u></u>

Provision for (Recovery of) Loan Losses

The provision for (recovery of) loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for (recovery of) 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 Bank did not record a provision for (recovery of) loan losses for 2016, which resulted in a total allowance for loan losses of \$5.3 million, or 1.09% of total loans, at December 31, 2016. This compared to a recovery of loan losses of \$100 thousand for 2015 and an allowance for loan losses of \$5.5 million, or 1.26% of total loans, at the prior year end.

A decrease in the specific reserve component of the allowance for loan losses was offset by an increase in the general reserve component, when comparing the allowance for loan losses at December 31, 2016 and 2015. As a result, the Bank did not record a provision for (recovery of) loan losses for the year ended December 31, 2016. The decrease in the specific reserve resulted from improvements in collateral positions on impaired loans, principal payments received, and the resolution of certain impaired loans during the year. The increase in the general reserve resulted primarily from the impact of \$47.1 million of loan growth during the year. The impact of loan growth on the general reserve was partially offset by improvements in the historical loss rate of the loan portfolio and asset quality, as evidenced by lower substandard loan amounts during the year. There was not a significant impact on the general reserve from changes in qualitative adjustment factors during 2016.

For the year ended December 31, 2015, the \$100 thousand recovery of loan losses resulted primarily from a decrease in the specific reserve component of the allowance for loan losses, when comparing the allowance for loan losses at December 31, 2015 and 2014. Overall, the general reserve increased as a result of loan growth during the year, but improvements in the historical loss rate and qualitative adjustment factors mitigated the effect of the loan growth on the allowance for loan losses at December 31, 2015. Improvements in qualitative adjustment factors resulted from improving value trends on residential real estate properties, economic conditions, and asset quality. The increase in the general reserve component of the allowance for loan losses was offset by the decrease in the specific reserve component primarily from principal payments received and increases in collateral values on impaired loans based on updated appraisals.

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The Company has consistently applied its allowance for loan loss methodology and regularly reviews the three year historical charge-off look back period to ensure it is indicative of the risk that remains in the loan portfolio. The Company has no reason to believe that net charge-offs experienced in 2017 will be significantly different from the prior three year look back period. For more detail of net charge-offs, see the allowance for loan losses table appearing in the Asset Quality section.

Noninterest Income

Noninterest income increased 2% to \$8.5 million for the year ended December 31, 2016 from \$8.3 million for the same period in 2015. Service charges on deposits increased \$470 thousand, ATM and check card fees increased \$142 thousand, income from bank owned life insurance increased \$52 thousand, and other operating income increased \$320 thousand. These increases were partially offset by wealth management fees that decreased \$613 thousand and bargain purchase gain that decreased \$201 thousand.

The increases in service charges on deposits and ATM and check card fees were primarily attributable to the Acquisition and the related increase in deposit balances. The increase in other operating income was primarily attributable to a \$102 thousand life insurance benefit recorded during the year and revenue of \$247 thousand that resulted from a three-year not-to-compete agreement with former employees. The not-to-compete agreement was related to the elimination of brokerage services on January 1, 2016.

The decrease in wealth management fees was attributable to the elimination of brokerage services referred to above and the decrease in bargain purchase gain resulted from the Acquisition, which occurred in 2015.

The \$102 thousand life insurance benefit recorded in other operating income during 2016 was offset by a \$100 thousand death benefit payment to the beneficiary. The \$100 thousand death benefit was recorded as other operating expense in the noninterest expense section of the consolidated statements of income.

Noninterest Expense

Noninterest expense decreased \$2.1 million, or 8%, to \$23.5 million for the year ended December 31, 2016, compared to \$25.6 million for the same period in 2015. Salaries and employee benefits decreased \$911 thousand, supplies expense decreased \$333 thousand, legal and professional fees decreased \$452 thousand, data processing expense decreased \$107 thousand, postage expense decreased \$103 thousand, bank franchise tax decreased \$141 thousand, and other real estate owned expense decreased \$472 thousand.

The expense categories described above that decreased in 2016 were partially offset by certain expense categories that increased during the year, including occupancy expenses that increased \$81 thousand, equipment expense that increased \$133 thousand, ATM and check card fees that increased \$85 thousand, FDIC assessment expense that increased \$42 thousand, and amortization expense that increased \$129 thousand. These increases were primarily a result of the Acquisition, which increased the number of banking locations and customer deposit balances for a full year during 2016, compared to only a portion of the same period in 2015.

Salaries and employee benefits decreased primarily from lower salaries and wage expense, insurance expense, and pension expense, which decreased \$501 thousand, \$314 thousand, and \$136 thousand, respectively. Salaries and wage expense was lower from a reduction in the number of employees when comparing the periods, primarily as a result of the Company's efforts to operate more efficiently. Insurance expense decreased as a result of changes to the Company's health insurance plan for 2016 as expense was impacted by the actual amount of claims submitted by employees during the year, as opposed to a fixed cost of insurance for 2015. Pension expense decreased when comparing the periods as a result of an amendment to the defined benefit pension plan and the Company's intention to terminate the plan. Under the amendment, benefit accruals ceased as of November 30, 2016. The decreases in supplies expense, legal and professional fees, data processing expense, and postage expense resulted primarily from integration expenses incurred during 2015 related to the Acquisition, which totaled \$325 thousand, \$258 thousand, \$145 thousand, and \$70 thousand for these categories, respectively. Total integration expenses related to the Acquisition were \$908 thousand for the year ended December 31, 2015. Bank franchise tax decreased due to the Bank's lower taxable capital from the redemption of preferred stock during 2015. Decreases in expenses related to other real estate owned resulted primarily from increased gains on the sale of OREO property and lower negative adjustments to the carrying value of OREO property.

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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 years ended December 31, 2016 and 2015. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income. For a more detailed discussion of the Company's tax calculation, see Note 11 to the consolidated financial statements, included in Item 8 of this Form 10-K.

Financial Condition

General

Total assets increased by \$23.7 million to \$716.0 million at December 31, 2016 compared to \$692.3 million at December 31, 2015. The increase was primarily attributable to a \$47.3 million increase in net loans, when comparing the periods. The increases in net loans were partially offset by a \$23.7 million decrease in securities since December 31, 2015.

Total deposits increased by \$18.5 million to \$645.6 million at December 31, 2016 compared to \$627.1 million at December 31, 2015. Noninterest-bearing demand deposits and savings and interest-bearing deposits increased \$11.0 million and \$20.1 million, respectively, when comparing the periods. These increases were partially offset by a \$12.7 million decrease in time deposits since December 31, 2015.

Loans

The Bank is an active lender with a loan portfolio that includes commercial and residential real estate loans, commercial loans, consumer loans, construction and land development loans and home equity loans. The Bank's lending activity is concentrated on individuals, small and medium-sized businesses and local governmental entities primarily 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.

Gross loan balances increased 11%, or \$47.1 million, to \$486.1 million at December 31, 2016, compared to \$439.0 million at December 31, 2015. Growth of the loan portfolio was led by other real estate loans with balances that increased \$29.8 million during 2016, followed by residential real estate loans with balances that increased by \$9.5 million.

The Bank's loan portfolio is summarized in the table below for the periods indicated (dollars in thousands).

	Loan Portfolio											
	At December 31,											
	2016		2015		2014		2013		2012			
Commercial, financial, and agricultural	\$ 29,981	6.17 %	\$ 24,048	5.48 %	\$ 21,166	5.59 %	\$ 22,803	6.39 %	\$ 23,071	6.39 %	\$ 23,071	6.39 %
Real estate - construction	34,699	7.14 %	33,135	7.55 %	29,475	7.79 %	34,060	9.54 %	43,524	10.13 %	43,524	10.13 %
Real estate - mortgage:												
Residential (1-4 family)	198,763	40.89 %	189,286	43.12 %	163,727	43.27 %	141,961	39.76 %	134,964	31.19 %	134,964	31.19 %
Other real estate loans	211,210	43.45 %	181,447	41.33 %	151,802	40.12 %	145,968	40.87 %	174,220	40.14 %	174,220	40.14 %
Consumer	4,875	1.00 %	4,312	0.98 %	5,070	1.34 %	5,214	1.46 %	7,144	1.63 %	7,144	1.63 %
All other loans	6,539	1.35 %	6,771	1.54 %	7,170	1.89 %	7,087	1.98 %	671	0.15 %	671	0.15 %
Total loans	\$ 486,067	100 %	\$ 438,999	100 %	\$ 378,410	100 %	\$ 357,093	100 %	\$ 383,594	100 %	\$ 383,594	100 %
Less:												
allowance for loan losses	5,321		5,524		6,718		10,644		13,075		13,075	
Loans, net of allowance for loan losses	\$ 480,746		\$ 433,475		\$ 371,692		\$ 346,449		\$ 370,519		\$ 370,519	

There was no category of loans that exceeded 10% of outstanding loans at December 31, 2016 that were not disclosed in the above table.

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The following table sets forth the maturities of the loan portfolio at December 31, 2016 (in thousands):

Remaining Maturities of Selected Loans				
At December 31, 2016				
	Less than One Year	One to Five Years	Greater than Five Years	Total
Commercial, financial, and agricultural	\$9,396	\$15,510	\$5,075	\$29,981
Real estate construction and land development	21,391	10,334	2,974	34,699
Real estate - mortgage:				
Residential (1-4 family)	19,196	40,952	138,615	198,763
Other real estate loans	22,149	41,298	147,763	211,210
Consumer	625	3,916	334	4,875
All other loans	570	5,843	126	6,539
Total loans	<u>\$73,327</u>	<u>\$117,853</u>	<u>\$294,887</u>	<u>\$486,067</u>

For maturities over one year:

Fixed rates	\$305,907
Variable rates	106,833
	<u>\$412,740</u>

Asset Quality

Management classifies non-performing assets as non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank when its customers do not meet the contractual obligation of their loans, either through foreclosure or through a deed in lieu thereof from the borrower and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is recorded at the lower of cost or fair value, less estimated selling costs, and is marketed by the Bank through brokerage channels. The Bank's OREO, net of valuation allowance, totaled \$250 thousand at December 31, 2016 and \$2.7 million at December 31, 2015. There was not a valuation allowance for other real estate owned at December 31, 2016. The valuation allowance for other real estate owned totaled \$224 thousand at December 31, 2015.

Non-performing assets were \$1.8 million and \$6.5 million at December 31, 2016 and 2015, representing 0.25% and 0.94% of total assets, respectively. Non-performing assets included \$1.5 million in non-accrual loans and \$250 thousand in OREO, net of the valuation allowance, at December 31, 2016. This compares to \$3.9 million in non-accrual loans and \$2.7 million in OREO, net of the valuation allowance, at December 31, 2015.

The levels of non-performing assets at December 31, 2016 and December 31, 2015 were primarily attributable to business customers involved in construction and land development that have not been able to meet their debt requirements because they have not fully recovered from the recent recession. At December 31, 2016, 59% of non-performing assets related to construction and land development loans, 23% related to residential real estate loans, 14% related to properties originally acquired for branch expansion no longer intended to be used for that purpose, and 4% related to commercial real estate loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower's ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. Other potential problem loans totaled \$8.1 million and \$10.3 million at December 31, 2016 and December 31, 2015, respectively. The amount of other potential problem loans in future periods may be dependent on economic conditions and other factors influencing our customers' ability to meet their debt requirements.

Loans greater than 90 days past due and still accruing totaled \$116 thousand at December 31, 2016, which was comprised of three loans expected to pay all principal and interest amounts contractually due to the Bank. There were \$92 thousand of loans greater than 90 days past due and still accruing at December 31, 2015.

The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for (or recovery of) loan losses is based upon management's current estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$5.3 million at December 31, 2016 and \$5.5 million at December 31, 2015, representing 1.09% and 1.26% of total loans, respectively. After analyzing the composition of the loan portfolio, related credit risks, and improvements in asset quality

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during recent years, the Company determined that the three year loss period and the qualitative adjustment factors that established the general reserve component of the allowance for loan losses were appropriate at December 31, 2016. For further discussion regarding the decrease in the allowance for loan losses, see “Provision for (Recovery of) Loan Losses” above.

Impaired loans totaled \$4.9 million at December 31, 2016, compared to \$7.7 million at December 31, 2015. The related allowance for loan losses provided for these loans totaled \$37 thousand and \$544 thousand at December 31, 2016 and 2015. The average recorded investment in impaired loans during 2016 and 2015 was \$7.0 million and \$10.5 million, respectively. Included in the impaired loans total are loans classified as troubled debt restructurings (TDRs) totaling \$460 thousand and \$982 thousand at December 31, 2016 and 2015. Loans classified as TDRs represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of December 31, 2016, \$300 thousand of these TDRs were performing under the restructured terms and were not considered non-performing assets.

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

	Allowance for Loan Losses				
	At December 31,				
	2016	2015	2014	2013	2012
Balance, beginning of period	\$ 5,524	\$ 6,718	\$ 10,644	\$ 13,075	\$ 12,937
Loans charged-off:					
Commercial, financial and agricultural	—	59	43	37	261
Real estate-construction and land development	—	—	91	2,962	431
Real estate-mortgage					
Residential (1-4 family)	83	142	272	260	761
Other real estate loans	165	1,125	203	1,070	2,154
Consumer	540	512	318	163	186
All other loans	—	—	—	—	—
Total loans charged off	<u>\$ 788</u>	<u>\$ 1,838</u>	<u>\$ 927</u>	<u>\$ 4,492</u>	<u>\$ 3,793</u>
Recoveries:					
Commercial, financial and agricultural	\$ 11	\$ 72	\$ 18	\$ 179	\$ 35
Real estate-construction and land development	4	4	80	—	1
Real estate-mortgage					
Residential (1-4 family)	293	373	15	823	68
Other real estate loans	2	2	509	1,304	64
Consumer	275	293	229	180	208
All other loans	—	—	—	—	—
Total recoveries	<u>\$ 585</u>	<u>\$ 744</u>	<u>\$ 851</u>	<u>\$ 2,486</u>	<u>\$ 376</u>
Net charge-offs	\$ 203	\$ 1,094	\$ 76	\$ 2,006	\$ 3,417
Provision for (recovery of) loan losses	—	(100)	(3,850)	(425)	3,555
Balance, end of period	<u>\$ 5,321</u>	<u>\$ 5,524</u>	<u>\$ 6,718</u>	<u>\$ 10,644</u>	<u>\$ 13,075</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	0.04 %	0.27 %	0.02 %	0.53 %	0.88 %

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The following table shows the balance of the Bank's allowance for loan losses allocated to each major category of loans and the ratio of related outstanding loan balances to total loans (dollars in thousands).

	Allocation of Allowance for Loan Losses									
	At December 31,									
	2016		2015		2014		2013		2012	
Commercial, financial and agricultural	\$ 380	6.17 %	\$ 306	5.48 %	\$ 310	5.59 %	\$ 442	6.39 %	\$ 608	6.01 %
Real estate-construction and land development	441	7.14 %	1,532	7.55 %	1,403	7.79 %	2,710	9.54 %	2,481	11.35 %
Real estate-mortgage										
Residential (1-4 family)	1,019	40.89 %	939	43.12 %	1,204	43.27 %	2,975	39.76 %	3,712	35.18 %
Other real estate loans	3,142	43.45 %	2,534	41.33 %	3,658	40.12 %	4,418	40.87 %	6,163	45.42 %
Consumer	267	1.00 %	140	0.98 %	67	1.34 %	24	1.46 %	101	1.86 %
All other loans	72	1.35 %	73	1.54 %	76	1.89 %	75	1.98 %	10	0.18 %
	<u>\$ 5,321</u>	<u>100.0 %</u>	<u>\$ 5,524</u>	<u>100.0 %</u>	<u>\$ 6,718</u>	<u>100.0 %</u>	<u>\$ 10,644</u>	<u>100.0 %</u>	<u>\$ 13,075</u>	<u>100.0 %</u>

The following table provides information on the Bank's non-performing assets at the dates indicated (dollars in thousands).

	Non-performing Assets				
	At December 31,				
	2016	2015	2014	2013	2012
Non-accrual loans	\$ 1,520	\$ 3,854	\$ 8,000	\$ 11,678	\$ 8,393
Other real estate owned	250	2,679	1,888	3,030	5,590
Total non-performing assets	<u>\$ 1,770</u>	<u>\$ 6,533</u>	<u>\$ 9,888</u>	<u>\$ 14,708</u>	<u>\$ 13,983</u>
Loans past due 90 days accruing interest	116	92	—	49	228
Total non-performing assets and past due loans	<u>\$ 1,886</u>	<u>\$ 6,625</u>	<u>\$ 9,888</u>	<u>\$ 14,757</u>	<u>\$ 14,211</u>
Troubled debt restructurings	\$ 460	\$ 982	\$ 1,918	\$ 1,941	\$ 6,326
Allowance for loan losses to period end loans	1.09 %	1.26 %	1.77 %	2.98 %	3.41 %
Non-performing assets to period end loans	0.36 %	1.49 %	2.61 %	4.12 %	3.65 %

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Securities

Securities at December 31, 2016 totaled \$149.7 million, a decrease of \$23.7 million or 14%, from \$173.5 million at the end of 2015. The investment portfolio decreased during 2016 as loan growth was partially funded by cash flow received from the securities portfolio. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities, corporate debt securities, and restricted securities. As of December 31, 2016, neither the Company nor the Bank held any derivative financial instruments in their respective investment security portfolios. Gross unrealized gains in the available for sale portfolio totaled \$333 thousand and \$601 thousand at December 31, 2016 and 2015, respectively. Gross unrealized losses in the available for sale portfolio totaled \$1.6 million and \$893 thousand at December 31, 2016 and 2015, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$19 thousand and \$264 thousand at December 31, 2016 and 2015, respectively. Gross unrealized losses in the held to maturity portfolio totaled \$708 thousand and \$345 thousand at December 31, 2016 and 2015, respectively. Investments in an unrealized loss position were considered temporarily impaired at December 31, 2016 and 2015. The change in the unrealized gains and losses of investment securities from December 31, 2015 to December 31, 2016 was related to changes in market interest rates and was not related to credit concerns of the issuers.

The following table summarizes the Company's securities portfolio on the dates indicated (in thousands).

	Securities Portfolio		
	At December 31,		
	2016	2015	2014
Securities available for sale, at fair value:			
U.S. agency and mortgage-backed securities	\$ 80,171	\$ 89,337	\$ 67,029
Obligations of state and political subdivisions	14,620	16,214	16,257
Corporate equity securities	11	8	6
	<u>\$ 94,802</u>	<u>\$ 105,559</u>	<u>\$ 83,292</u>
Securities held to maturity, at carrying value			
U.S. agency and mortgage-backed securities	\$ 37,269	\$ 49,662	\$ —
Obligations of state and political subdivisions	14,629	15,357	—
Corporate debt securities	1,500	1,500	—
	<u>\$ 53,398</u>	<u>\$ 66,519</u>	<u>\$ —</u>
Restricted securities, at cost			
Federal Home Loan Bank stock	\$ 623	\$ 466	\$ 470
Federal Reserve Bank stock	875	875	846
Community Bankers' Bank stock	50	50	50
	<u>\$ 1,548</u>	<u>\$ 1,391</u>	<u>\$ 1,366</u>
Total securities	<u><u>\$ 149,748</u></u>	<u><u>\$ 173,469</u></u>	<u><u>\$ 84,658</u></u>

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The following table shows the maturities of debt and equity securities at amortized cost and market value at December 31, 2016 and approximate weighted average yields of such securities (dollars in thousands). Yields on state and political subdivision securities are shown on a tax equivalent basis, assuming a 34% federal income tax rate. The Company attempts to maintain diversity in its portfolio and maintain credit quality and re-pricing terms that are consistent with its asset/liability management and investment practices and policies. For further information on securities, see Note 2 to the consolidated financial statements, included in Item 8 of this Form 10-K.

Securities Portfolio Maturity Distribution/Yield Analysis					
At December 31, 2016					
	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years and Equity Securities	Total
U.S. agency and mortgage-backed securities					
Amortized cost	\$ —	\$ 7,151	\$ 20,164	\$ 91,405	\$ 118,720
Market value	\$ —	\$ 7,056	\$ 19,970	\$ 89,932	\$ 116,958
Weighted average yield	0.00 %	1.63 %	2.32 %	2.17 %	2.16 %
Obligations of state and political subdivisions					
Amortized cost	\$ 471	\$ 5,175	\$ 10,494	\$ 13,143	\$ 29,283
Market value	\$ 473	\$ 5,235	\$ 10,398	\$ 12,950	\$ 29,056
Weighted average yield	2.00 %	3.20 %	3.29 %	3.49 %	3.34 %
Corporate equity securities					
Amortized cost	\$ —	\$ —	\$ —	\$ 1	\$ 1
Market value	\$ —	\$ —	\$ —	\$ 11	\$ 11
Weighted average yield	0.00 %	0.00 %	0.00 %	1.02 %	1.02 %
Corporate debt securities					
Amortized cost	\$ —	\$ —	\$ 1,500	\$ —	\$ 1,500
Market value	\$ —	\$ —	\$ 1,486	\$ —	\$ 1,486
Weighted average yield	0.00 %	0.00 %	6.88 %	0.00 %	6.88 %
Restricted securities					
Amortized cost	\$ —	\$ —	\$ —	\$ 1,548	\$ 1,548
Market value	\$ —	\$ —	\$ —	\$ 1,548	\$ 1,548
Weighted average yield	0.00 %	0.00 %	0.00 %	5.17 %	5.17 %
Total portfolio					
Amortized cost	\$ 471	\$ 12,326	\$ 32,158	\$ 106,097	\$ 151,052
Market value	\$ 473	\$ 12,291	\$ 31,854	\$ 104,441	\$ 149,059
Weighted average yield (1)	2.00 %	2.29 %	2.85 %	2.37 %	2.47 %

(1) Yields on tax-exempt securities have been calculated on a tax-equivalent basis.

The above table was prepared using the contractual maturities for all securities with the exception of mortgage-backed securities (MBS) and collateralized mortgage obligations (CMO). Both MBS and CMO securities were recorded using the yield book prepayment model that incorporates four causes of prepayments including home sales, refinancing, defaults, and curtailments/full payoffs.

As of December 31, 2016, the Company did not own securities of any issuer for which the aggregate book value of the securities of such issuer exceeded ten percent of shareholders' equity.

Deposits

At December 31, 2016, deposits totaled \$645.6 million, an increase of \$18.5 million, from \$627.1 million at December 31, 2015. There was not a significant change in the deposit mix when comparing the periods. At December 31, 2016, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 26%, 54%, and 20% of total deposits, respectively, compared to 25%, 52%, and 23% at December 31, 2015.

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The following tables include a summary of average deposits and average rates paid and maturities of CD's greater than \$100,000 (dollars in thousands).

Average Deposits and Rates Paid						
Year Ended December 31,						
	2016		2015		2014	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing deposits	\$ 161,882	—	\$ 138,193	—	\$ 101,209	—
Interest-bearing deposits:						
Interest checking	\$ 150,412	0.26 %	\$ 135,976	0.14 %	\$ 112,972	0.15 %
Money market	61,086	0.17 %	46,161	0.13 %	19,155	0.11 %
Savings	126,434	0.08 %	114,632	0.08 %	101,793	0.09 %
Time deposits:						
Less than \$100	87,828	0.44 %	83,280	0.39 %	62,623	0.86 %
Greater than \$100	45,925	0.80 %	49,511	0.95 %	47,963	1.23 %
Brokered deposits	600	0.45 %	767	0.50 %	4,756	0.59 %
Total interest-bearing deposits	\$ 472,285	0.29 %	\$ 430,327	0.27 %	\$ 349,262	0.41 %
Total deposits	\$ 634,167		\$ 568,520		\$ 450,471	

Maturities of CD's Greater than \$100,000

	Less than Three Months	Three to Six Months	Six to Twelve Months	Greater than One Year	Total
At December 31, 2016	\$ 6,687	\$ 3,536	\$ 7,572	\$ 25,285	\$ 43,080

The table above includes brokered deposits greater than \$100 thousand.

Liquidity

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

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

At December 31, 2016, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$114.9 million. At December 31, 2016, 15% or \$73.3 million of the loan portfolio matures within one year. Non-deposit sources of available funds totaled \$125.6 million at December 31, 2016, which included \$82.7 million available from Federal Home Loan Bank of Atlanta (FHLB), \$42.0 million of unsecured federal funds lines of credit with other correspondent banks and \$893 thousand available through the Federal Reserve Discount Window.

Subordinated Debt

See Note 9 to the consolidated financial statements, included in Item 8 of this Form 10-K, for discussion of subordinated debt.

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Junior Subordinated Debt

See Note 10 to the consolidated financial statements, included in Item 8 of this Form 10-K, for discussion of junior subordinated debt.

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.

At December 31, 2016 and 2015, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	<u>2016</u>	<u>2015</u>
Commitments to extend credit and unfunded commitments under lines of credit	\$ 71,421	\$ 61,115
Stand-by letters of credit	8,983	7,732

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

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and usually do not contain a specified maturity date and may or may 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 December 31, 2016, the Bank had \$10.1 million in locked-rate commitments to originate mortgage loans. 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.

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 Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital.

In July 2013, the U.S. banking regulators adopted a final rule which implements the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision, and certain changes required by the Dodd-Frank Act. The final rule established an integrated regulatory capital framework and introduces the "Standardized Approach" for risk-weighted assets, which replaced the Basel I risk-based guidance for determining risk-weighted assets as of January 1, 2015, the date the Bank became subject to the new rules. Based on the Bank's current capital composition and levels, the Bank believes it is in compliance with the requirements as set forth in the final rules.

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The rules included new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019, and refined the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Bank under the final rules were as follows: a new common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6% (increased from 4%); a total capital ratio of 8% (unchanged from previous rules); and a Tier 1 leverage ratio of 4% for all institutions. The final rules also established a “capital conservation buffer” above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years, which began on January 1, 2016, as follows: the maximum buffer was 0.625% of risk-weighted assets for 2016, and will be 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: a common equity Tier 1 capital ratio of 7.0%, a Tier 1 capital ratio of 8.5%, and a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions. Management believes, as December 31, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

The Bank’s capital and related ratios decreased during 2015 primarily due to the declaration and payment of cash dividends on common stock to the Company totaling \$13.5 million combined with the net increase of \$187.0 million in assets from the Acquisition. The following table summarizes the Bank’s regulatory capital and related ratios at December 31, 2016, 2015 and 2014 (dollars in thousands).

	Analysis of Capital		
	At December 31,		
	<u>2016</u>	<u>2015</u>	<u>2014</u>
Common equity Tier 1 capital	\$ 60,269	\$ 55,989	\$ N/A
Tier 1 capital	60,269	55,989	67,217
Tier 2 capital	5,321	5,524	4,724
Total risk-based capital	65,590	61,513	71,941
Risk-weighted assets	486,885	443,717	375,956
Capital ratios:			
Common equity Tier 1 capital ratio	12.38 %	12.62 %	N/A
Tier 1 capital ratio	12.38 %	12.62 %	17.88 %
Total capital ratio	13.47 %	13.86 %	19.14 %
Leverage ratio (Tier 1 capital to average assets)	8.48 %	8.12 %	12.90 %
Capital conservation buffer ratio ⁽¹⁾	5.47 %	N/A	N/A

Calculated by subtracting the regulatory minimum capital ratio requirements from the Company’s actual ratio for

(1) Common equity Tier 1, Tier 1, and Total risk based capital. The lowest of the three measures represents the Bank’s capital conservation buffer ratio.

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are now required to meet the following increased capital level requirements in order to qualify as “well capitalized:” a new common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8% (increased from 6%); a total capital ratio of 10% (unchanged from previous rules); and a Tier 1 leverage ratio of 5% (unchanged from previous rules).

On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B totaling \$695 thousand. While the preferred stock was outstanding, the Company’s Series A Preferred Stock paid a dividend of 5% per annum until May 14, 2014 and 9% thereafter, and the Series B Preferred Stock paid a dividend of 9% per annum.

During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 to which the Company issued a subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note is intended to qualify as Tier 2 capital for regulatory capital purposes. The Note has a maturity date of October 1, 2025. The Company used the proceeds from the dividends and from the issuance of the Note to redeem all outstanding preferred stock.

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Recent Accounting Pronouncements

See Note 1 to the consolidated financial statements, included in Item 8 of this Form 10-K, for discussion of recent accounting pronouncements.

Quarterly Results

The table below lists the Company's quarterly performance for the years ended December 31, 2016 and 2015 (in thousands, except per share data).

	2016				
	Fourth	Third	Second	First	Total
Interest and dividend income	\$6,426	\$6,342	\$6,278	\$6,191	\$25,237
Interest expense	513	495	482	492	1,982
Net interest income	5,913	5,847	5,796	5,699	23,255
Provision for loan losses	—	—	—	—	—
Net interest income after provision for loan losses	5,913	5,847	5,796	5,699	23,255
Noninterest income	2,127	2,311	2,112	1,943	8,493
Noninterest expense	5,635	5,853	5,883	6,117	23,488
Income before income taxes	2,405	2,305	2,025	1,525	8,260
Income tax expense	724	611	592	426	2,353
Net income	\$1,681	\$1,694	\$1,433	\$1,099	\$5,907
Net income available to common shareholders	\$1,681	\$1,694	\$1,433	\$1,099	\$5,907
Net income per share, basic	\$0.34	\$0.34	\$0.29	\$0.22	\$1.20
Net income per share, diluted	\$0.34	\$0.34	\$0.29	\$0.22	\$1.20
	2015				
	Fourth	Third	Second	First	Total
Interest and dividend income	\$6,021	\$5,764	\$5,392	\$4,988	\$22,165
Interest expense	423	338	324	356	1,441
Net interest income	5,598	5,426	5,068	4,632	20,724
Recovery of loan losses	—	—	(100)	—	(100)
Net interest income after recovery of loan losses	5,598	5,426	5,168	4,632	20,824
Noninterest income	2,198	2,244	2,309	1,591	8,342
Noninterest expense	6,512	6,701	6,855	5,487	25,555
Income before income taxes	1,284	969	622	736	3,611
Income tax expense	343	243	178	192	956
Net income	\$941	\$726	\$444	\$544	\$2,655
Net income available to common shareholders	\$813	\$398	\$116	\$215	\$1,542
Net income per share, basic	\$0.17	\$0.08	\$0.02	\$0.04	\$0.31
Net income per share, diluted	\$0.17	\$0.08	\$0.02	\$0.04	\$0.31

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not required.

Item 8. Financial Statements and Supplementary Data

The Consolidated Financial Statements and related footnotes of the Company are presented below followed by the financial statements of the Parent.

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To the Shareholders March 29, 2017
First National Corporation
Strasburg, Virginia

MANAGEMENT’S REPORT REGARDING THE EFFECTIVENESS OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of First National Corporation (the Company) is responsible for the preparation, integrity and fair presentation of the financial statements included in the annual report as of December 31, 2016. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management’s judgments and estimates concerning the effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining an effective internal control structure over financial reporting. The Company’s internal control over financial reporting includes those policies and procedures that pertain to the Company’s ability to record, process, summarize and report reliable financial data. The internal control system contains monitoring mechanisms, and appropriate actions are taken to correct identified deficiencies. Management believes that internal controls over financial reporting, which are subject to scrutiny by management and the Company’s internal auditor, support the integrity and reliability of the financial statements. Management recognizes that there are inherent limitations in the effectiveness of any internal control system, including the possibility of human error and the circumvention or overriding of internal controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. In addition, because of changes in conditions and circumstances, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the Company’s internal control structure over financial reporting is effective, management assessed these controls as they conformed to accounting principles generally accepted in the United States of America and related call report instructions as of December 31, 2016. This assessment was based on criteria for effective internal control over financial reporting as described in “Internal Control - Integrated Framework (2013)” issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management believes that the Company maintained effective internal controls over financial reporting as of December 31, 2016. Management’s assessment did not determine any material weakness within the Company’s internal control structure. The Company’s annual report does not include an attestation report of the Company’s registered public accounting firm, Yount, Hyde & Barbour, P.C. (YHB), regarding internal control over financial reporting. Management’s report was not subject to attestation by YHB pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management’s report in its annual report.

The 2016 end of year consolidated financial statements have been audited by the independent registered public accounting firm of Yount, Hyde & Barbour, P.C. (YHB). Personnel from YHB were given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and Committees thereof.

Management believes that all representations made to the independent auditors were valid and appropriate. The resulting report from YHB accompanies the consolidated financial statements.

The Board of Directors of the Company, acting through its Audit Committee (the Committee), is responsible for the oversight of the Company’s accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent auditors and approves decisions regarding the appointment or removal of members of the internal audit function. The Committee meets periodically with management, the independent auditors, and the internal auditor to insure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Company in addition to reviewing the Company’s financial reports. The independent auditors and the internal auditor have full and unlimited access to the Audit Committee, with or without the presence of the management of the Company, to discuss the adequacy of internal control over financial reporting, and any other matters which they believe should be brought to the attention of the Audit Committee.

<u>/s/ Scott C. Harvard</u>	<u>/s/ M. Shane Bell</u>
Scott C. Harvard	M. Shane Bell
President	Executive Vice President

Chief Executive Officer Chief Financial Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
First National Corporation

We have audited the accompanying consolidated balance sheets of First National Corporation and subsidiary as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First National Corporation and subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Yount, Hyde & Barbour, P.C.
Winchester, Virginia
March 29, 2017

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FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

December 31, 2016 and 2015

(in thousands, except share and per share data)

	<u>2016</u>	<u>2015</u>
Assets		
Cash and due from banks	\$ 10,106	\$ 8,247
Interest-bearing deposits in banks	30,986	31,087
Securities available for sale, at fair value	94,802	105,559
Securities held to maturity, at carrying value (fair value, 2016, \$52,709; 2015, \$66,438)	53,398	66,519
Restricted securities, at cost	1,548	1,391
Loans held for sale	337	323
Loans, net of allowance for loan losses, 2016, \$5,321, 2015, \$5,524	480,746	433,475
Other real estate owned, net of valuation allowance, 2016, \$0, 2015, \$224	250	2,679
Premises and equipment, net	20,785	21,389
Accrued interest receivable	1,746	1,661
Bank owned life insurance	13,928	11,742
Core deposit intangibles, net	1,551	2,322
Other assets	5,817	5,927
Total assets	<u>\$ 716,000</u>	<u>\$ 692,321</u>
Liabilities & Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 168,076	\$ 157,070
Savings and interest-bearing demand deposits	349,067	328,945
Time deposits	128,427	141,101
Total deposits	<u>\$ 645,570</u>	<u>\$ 627,116</u>
Subordinated debt	4,930	4,913
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	4,070	5,060
Total liabilities	<u>\$ 663,849</u>	<u>\$ 646,368</u>
Shareholders' Equity		
Preferred stock, par value \$1.25 per share; authorized 1,000,000 shares; none issued and outstanding	\$ —	\$ —
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2016, 4,929,403 shares, 2015, 4,916,130 shares	6,162	6,145
Surplus	7,093	6,956
Retained earnings	39,756	34,440
Accumulated other comprehensive loss, net	(860)	(1,588)
Total shareholders' equity	<u>\$ 52,151</u>	<u>\$ 45,953</u>
Total liabilities and shareholders' equity	<u>\$ 716,000</u>	<u>\$ 692,321</u>

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Income
Years Ended December 31, 2016 and 2015
(in thousands, except per share data)

	<u>2016</u>	<u>2015</u>
Interest and Dividend Income		
Interest and fees on loans	\$ 21,662	\$ 19,138
Interest on deposits in banks	238	197
Interest and dividends on securities:		
Taxable interest	2,692	2,358
Tax-exempt interest	564	395
Dividends	81	77
Total interest and dividend income	<u>\$ 25,237</u>	<u>\$ 22,165</u>
Interest Expense		
Interest on deposits	\$ 1,353	\$ 1,150
Interest on federal funds purchased	3	2
Interest on subordinated debt	361	62
Interest on junior subordinated debt	259	224
Interest on other borrowings	6	3
Total interest expense	<u>\$ 1,982</u>	<u>\$ 1,441</u>
Net interest income	<u>\$ 23,255</u>	<u>\$ 20,724</u>
Recovery of loan losses	—	(100)
Net interest income after recovery of loan losses	<u>\$ 23,255</u>	<u>\$ 20,824</u>
Noninterest Income		
Service charges on deposit accounts	\$ 3,512	\$ 3,042
ATM and check card fees	2,037	1,895
Wealth management fees	1,362	1,975
Fees for other customer services	581	606
Income from bank owned life insurance	425	373
Net gains (losses) on calls and sales of securities available for sale	8	(55)
Net gains on sale of loans	144	201
Bargain purchase gain	—	201
Other operating income	424	104
Total noninterest income	<u>\$ 8,493</u>	<u>\$ 8,342</u>

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FIRST NATIONAL CORPORATION
Consolidated Statements of Income

(Continued)

Years Ended December 31, 2016 and 2015

(in thousands, except per share data)

	<u>2016</u>	<u>2015</u>
Noninterest Expense		
Salaries and employee benefits	\$ 12,939	\$ 13,850
Occupancy	1,533	1,452
Equipment	1,634	1,501
Marketing	562	530
Supplies	450	783
Legal and professional fees	884	1,336
ATM and check card fees	866	781
FDIC assessment	426	384
Bank franchise tax	372	513
Telecommunications expense	451	436
Data processing expense	593	700
Postage expense	238	341
Amortization expense	771	642
Other real estate owned (income) expense, net	(120)	352
Net loss on disposal of premises and equipment	8	—
Other operating expense	1,881	1,954
Total noninterest expense	<u>\$ 23,488</u>	<u>\$ 25,555</u>
Income before income taxes	\$ 8,260	\$ 3,611
Income tax expense	2,353	956
Net income	<u>\$ 5,907</u>	<u>\$ 2,655</u>
Effective dividend on preferred stock	—	1,113
Net income available to common shareholders	<u>\$ 5,907</u>	<u>\$ 1,542</u>
Earnings per common share		
Basic	\$ 1.20	\$ 0.31
Diluted	\$ 1.20	\$ 0.31

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2016 and 2015
(in thousands)

	<u>2016</u>	<u>2015</u>
Net income	\$ 5,907	\$ 2,655
Other comprehensive income (loss), net of tax:		
Unrealized holding losses on available for sale securities, net of tax (\$341) and (\$50), respectively	(663)	(95)
Reclassification adjustment for (gains) losses included in net income, net of tax (\$3) and \$19, respectively	(5)	36
Pension liability adjustment, net of tax \$719 and \$13, respectively	1,396	25
Total other comprehensive income (loss)	<u>728</u>	<u>(34)</u>
Total comprehensive income	<u>\$ 6,635</u>	<u>\$ 2,621</u>

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
Years Ended December 31, 2016 and 2015
(in thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities		
Net income	\$ 5,907	\$ 2,655
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	1,356	1,231
Amortization of core deposit intangibles	771	642
Amortization of debt issuance costs	17	3
Origination of loans held for sale	(9,281)	(14,163)
Proceeds from sale of loans held for sale	9,411	14,369
Net gains on sales of loans held for sale	(144)	(201)
Recovery of loan losses	—	(100)
Net (gains) losses on calls and sales of securities available for sale	(8)	55
Provision for other real estate owned	27	230
Net gains on sale of other real estate owned	(193)	(74)
Income from bank owned life insurance	(425)	(373)
Accretion of discounts and amortization of premiums on securities, net	842	721
Accretion of premium on time deposits	(167)	(227)
Stock-based compensation	113	99
Bargain purchase gain on branch acquisition	—	(201)
Losses on disposal of premises and equipment	8	—
Deferred income tax expense	428	134
Changes in assets and liabilities:		
Increase in interest receivable	(85)	(400)
Decrease in other assets	26	40
Increase in accrued expenses and other liabilities	406	161
Net cash provided by operating activities	<u>\$ 9,009</u>	<u>\$ 4,601</u>
Cash Flows from Investing Activities		
Proceeds from maturities, calls, principal payments, and sales of securities available for sale	\$ 22,826	\$ 17,725
Proceeds from maturities, calls, principal payments, and sales of securities held to maturity	12,821	2,341
Purchases of securities available for sale	(13,615)	(40,723)
Purchases of securities held to maturity	—	(68,995)
Net purchase of restricted securities	(157)	(25)
Purchase of premises and equipment	(1,033)	(1,999)
Proceeds from sale of premises and equipment	23	—
Proceeds from sale of other real estate owned	2,882	717
Purchase of bank owned life insurance	(2,011)	(12)
Proceeds from cash value of bank owned life insurance	250	—
Net increase in loans	(47,308)	(63,346)
Acquisition of branches, net cash paid	—	179,501
Net cash (used in) provided by investing activities	<u>\$ (25,322)</u>	<u>\$ 25,184</u>

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows

(Continued)

Years Ended December 31, 2016 and 2015

(in thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$ 31,128	\$ 17,514
Net decrease in time deposits	(12,507)	(21,311)
Decrease in federal funds purchased	—	(52)
Net decrease in other borrowings	—	(26)
Proceeds from subordinated debt, net of issuance costs	—	4,910
Cash dividends paid on common stock, net of reinvestment	(550)	(454)
Cash dividends paid on preferred stock	—	(1,281)
Repurchase of common stock	—	(1)
Redemption of preferred stock	—	(14,595)
Net cash provided by (used in) financing activities	<u>\$ 18,071</u>	<u>\$ (15,296)</u>
Increase in cash and cash equivalents	\$ 1,758	\$ 14,489
Cash and Cash Equivalents		
Beginning	39,334	24,845
Ending	<u>\$ 41,092</u>	<u>\$ 39,334</u>
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	<u>\$ 2,172</u>	<u>\$ 1,685</u>
Income taxes	<u>\$ 1,974</u>	<u>\$ 929</u>
Supplemental Disclosures of Noncash Transactions		
Unrealized losses on securities available for sale	<u>\$ (1,012)</u>	<u>\$ (90)</u>
Change in pension liability	<u>\$ 2,115</u>	<u>\$ 38</u>
Transfer from loans to other real estate owned	<u>\$ 37</u>	<u>\$ 1,664</u>
Transfer from premises and equipment to other real estate owned	<u>\$ 250</u>	<u>\$ —</u>
Issuance of common stock, dividend reinvestment plan	<u>\$ 41</u>	<u>\$ 37</u>
Transactions Related to Acquisition		
Assets acquired	\$ —	\$ 193,638
Liabilities assumed	—	186,819
Net assets acquired	<u>\$ —</u>	<u>\$ 6,819</u>

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Shareholders' Equity
 Years Ended December 31, 2016 and 2015
(in thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2014	\$ 14,595	\$ 6,131	\$ 6,835	\$ 33,557	\$ (1,554)	\$ 59,564
Net income	—	—	—	2,655	—	2,655
Other comprehensive loss	—	—	—	—	(34)	(34)
Cash dividends on common stock (\$0.10 per share)	—	—	—	(491)	—	(491)
Stock-based compensation	—	—	99	—	—	99
Issuance of 4,109 shares common stock, dividend reinvestment plan	—	5	32	—	—	37
Issuance of 7,582 shares common stock, stock incentive plan	—	9	(9)	—	—	—
Repurchase of 138 shares common stock, stock incentive plan	—	—	(1)	—	—	(1)
Cash dividends on preferred stock	—	—	—	(1,281)	—	(1,281)
Redemption of preferred stock	(14,595)	—	—	—	—	(14,595)
Balance, December 31, 2015	<u>\$ —</u>	<u>\$ 6,145</u>	<u>\$ 6,956</u>	<u>\$ 34,440</u>	<u>\$ (1,588)</u>	<u>\$ 45,953</u>
	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2015	\$ —	\$ 6,145	\$ 6,956	\$ 34,440	\$ (1,588)	\$ 45,953
Net income	—	—	—	5,907	—	5,907
Other comprehensive income	—	—	—	—	728	728
Cash dividends on common stock (\$0.12 per share)	—	—	—	(591)	—	(591)
Stock-based compensation	—	—	113	—	—	113
Issuance of 3,949 shares common stock, dividend reinvestment plan	—	5	36	—	—	41
Issuance of 9,324 shares common stock, stock incentive plan	—	12	(12)	—	—	—
Balance, December 31, 2016	<u>\$ —</u>	<u>\$ 6,162</u>	<u>\$ 7,093</u>	<u>\$ 39,756</u>	<u>\$ (860)</u>	<u>\$ 52,151</u>

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION **Notes to Consolidated Financial Statements**

Note 1. Nature of Banking Activities and Significant Accounting Policies

First National Corporation (the Company) is the bank 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 and are not included in the Company's consolidated financial statements in accordance with authoritative accounting guidance because management has determined that the Trusts qualify as variable interest entities. The Bank owns First Bank Financial Services, Inc., which invests in entities that provide title insurance and investment services. The Bank owns Shenandoah Valley Land Holdings, LLC which holds other real estate owned. The Bank provides loan, deposit, wealth management and other products and services in the Shenandoah Valley and central regions of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, money market accounts, individual retirement accounts, certificates of deposit and cash management accounts. The Bank offers other services, including internet banking, mobile banking, remote deposit capture and other traditional banking services.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to accepted practices within the banking industry.

Principles of Consolidation

The consolidated financial statements of First National Corporation include the accounts of all six companies. All material intercompany balances and transactions have been eliminated in consolidation, except for balances and transactions related to the Trusts. The subordinated debt of these Trusts is reflected as a liability of the Company.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of other real estate owned, valuation of core deposit intangibles, pension obligations and other-than-temporary impairment of securities.

Significant Group Concentrations of Credit Risk

Most of the Company's activities are with customers located within the Shenandoah Valley and central regions of Virginia. The types of lending that the Company engages in are included in Note 3. The Company has a concentration of credit risk in commercial real estate, but does not have a significant concentration to any one customer or industry.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, the Company has defined cash equivalents as those amounts included in the balance sheet captions "Cash and due from banks" and "Interest-bearing deposits in banks."

Securities

Investments in debt securities with readily determinable fair values are classified as either held to maturity (HTM), available for sale (AFS) or trading based on management's intent. Currently, all of the Company's debt securities are classified as either AFS or HTM. Equity investments in the FHLB, the Federal Reserve Bank of Richmond and Community Bankers Bank are separately classified as restricted securities and are carried at cost. AFS securities are carried at estimated fair value with the corresponding unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss), and HTM securities are carried at amortized cost. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains or losses on the sale of securities are recorded on the trade date using the amortized cost of the specific security sold.

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Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either the Company (1) intends to sell the security or (2) it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more-than-likely that it will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss).

For equity securities carried at cost, such as restricted securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income.

The Company regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the Company's intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or estimated fair value. The Company, through its banking subsidiary, requires a firm purchase commitment from a permanent investor before loans held for sale can be closed, thus limiting interest rate risk. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

The Bank enters into commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans that are intended to be sold are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 60 days. The Bank protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Bank commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Bank is not exposed to losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Bank determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the value of the underlying asset while taking into consideration the probability that the rate lock commitments will close. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on the rate lock commitments.

Loans

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The Bank segments its loan portfolio into real estate loans, commercial and industrial loans, and consumer and other loans. Real estate loans are further divided into the following classes: Construction and Land Development; 1-4 Family Residential; and Other Real Estate Loans. Descriptions of the Company's loan classes are as follows:

Real Estate Loans – Construction and Land Development: The Company originates construction loans for the acquisition and development of land and construction of condominiums, townhomes, and one-to-four family residences.

Real Estate Loans – 1-4 Family: This class of loans includes loans secured by one-to-four family homes. In addition to traditional residential mortgage loans secured by a first or junior lien on the property, the Bank offers home equity lines of credit.

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Real Estate Loans – Other: This loan class consists primarily of loans secured by various types of commercial real estate typically in the Bank’s market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches.

Commercial and Industrial Loans: Commercial loans are typically secured with non-real estate commercial property. The Company makes commercial loans primarily to businesses located within its market area.

Consumer and Other Loans: Consumer loans include all loans made to individuals for consumer or personal purposes. They include new and used automobile loans, unsecured loans and lines of credit.

A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate throughout the Shenandoah Valley region of Virginia. The ability of the Bank’s debtors to honor their contracts may be impacted by the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances less the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued and credited to income based on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

A loan’s past due status is based on the contractual due date of the most delinquent payment due. Loans are generally placed on non-accrual status when the collection of principal or interest is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Loans greater than 90 days past due may remain on accrual status if management determines it has adequate collateral to cover the principal and interest. For those loans that are carried on non-accrual status, payments are first applied to principal outstanding. A loan may be returned to accrual status if the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms of the loan and there is reasonable assurance the borrower will continue to make payments as agreed. These policies are applied consistently across the loan portfolio.

All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. When a loan is returned to accrual status, interest income is recognized based on the new effective yield to maturity of the loan.

Any unsecured loan that is deemed uncollectible is charged-off in full. Any secured loan that is considered by management to be uncollectible is partially charged-off and carried at the fair value of the collateral less estimated selling costs. This charge-off policy applies to all loan segments.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Additionally, management generally evaluates substandard and doubtful loans greater than \$250 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company typically does not separately identify individual consumer, residential and certain small commercial loans that are less than \$250 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below.

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Troubled Debt Restructurings (TDR)

In situations where, for economic or legal reasons related to a borrower's financial condition, management grants a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower's payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on non-accrual status at the time of the TDR, the loan will remain on non-accrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above. There were \$460 thousand and \$982 thousand in loans classified as TDRs as of December 31, 2016 and 2015, respectively.

Allowance for Loan Losses

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

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company performs regular credit reviews of the loan portfolio to review credit quality and adherence to underwriting standards. The credit reviews consist of reviews by its internal credit administration department and reviews performed by an independent third party. Upon origination, each loan is assigned a risk rating ranging from one to nine, with loans closer to one having less risk. This risk rating scale is our primary credit quality indicator. The Company has various committees that review and ensure that the allowance for loans losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio.

The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of the collateral, overall portfolio quality and review of specific potential losses. The evaluation also considers the following risk characteristics of each loan portfolio class:

- 1-4 family residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

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

- Other real estate loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because repayment of these loans may be dependent upon the profitability and cash flows of the business or project.

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

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

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

The general component covers loans that are not considered impaired and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is calculated by loan type and uses an average loss rate during the preceding twelve quarters. The qualitative factors are assigned by management based on delinquencies and asset quality, national and local economic trends, effects of the changes in the value of underlying collateral, trends in volume and nature of loans, effects of changes in the lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan type. The general allowance estimates losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management's assessment of the above described factors and the relative weights given to each factor.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to forty years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less. Software is amortized over its estimated useful life ranging from three to seven years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

Other Real Estate Owned

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

Bank-Owned Life Insurance

The Company owns insurance on the lives of a certain group of key employees. The policies were purchased to help offset the increase in the costs of various fringe benefit plans, including healthcare. The cash surrender value of these policies is included as an asset on the consolidated balance sheets, and any increase in cash surrender value is recorded as income from bank owned life insurance on the consolidated statements of income. In the event of the death of an insured individual under these policies, the Company receives a death benefit which is recorded as other income. For the year ended December 31, 2016, the Company recorded \$102 thousand of death benefits received as other income under these policies. The Company did not receive any death benefits for the year ended December 31, 2015.

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Intangible Assets

Intangible assets consist of core deposit intangible assets arising from branch acquisitions which are amortized on an accelerated method over their estimated useful lives, which range from six to nine years.

Stock Based Compensation

Compensation cost is recognized for restricted stock units and other stock awards issued to employees and directors based on the fair value of the awards at the date of grant. The market price of the Company's common stock at the date of grant is used to estimate the fair value of restricted stock units and other stock awards.

Retirement Plans

Pension expense is the net of service and interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Employee 401(k) and profit sharing plan expense is the amount of matching contributions and Bank discretionary matches.

Transfers of Financial Assets

Transfers of financial assets, including loan participations, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

Income Taxes

The Company accounts for income taxes in accordance with ASC Topic 740, "Income Taxes". Under this guidance, deferred taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates that will apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date. See Note 11 for details on the Company's income taxes.

The Company regularly reviews the carrying amount of its net deferred tax assets to determine if the establishment of a valuation allowance is necessary. If based on the available evidence, it is more likely than not that all or a portion of the Company's net deferred tax assets will not be realized in future periods, a deferred tax valuation allowance would be established. Consideration is given to various positive and negative factors that could affect the realization of the deferred tax assets. In evaluating this available evidence, management considers, among other things, historical performance, expectations of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with utilization of operating loss and tax credit carry forwards not expiring, tax planning strategies and timing of reversals of temporary differences. Significant judgment is required in assessing future earnings trends and the timing of reversals of temporary differences. The Company's evaluation is based on current tax laws as well as management's expectations of future performance.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. There was no liability for unrecognized tax benefits recorded as of December 31, 2016 and 2015. Interest and penalties associated with unrecognized tax benefits, if any, are classified as additional income taxes in the consolidated statements of income.

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Wealth Management Department

Securities and other property held by the wealth management department in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflect 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. Shares not committed to be released under the Company's leveraged Employee Stock Ownership Plan (ESOP) are not considered to be outstanding. See Note 14 for further information regarding earnings per common share and see Note 13 for further information on the Company's ESOP.

Advertising Costs

The Company follows the policy of charging the production costs of advertising to expense as incurred. Total advertising expense incurred for 2016 and 2015 was \$402 thousand and \$400 thousand, respectively.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities and pension liability adjustments, are reported as a separate component of the equity section of the consolidated balance sheets, such items, along with net income, are components of comprehensive income.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are such matters that will have a material effect on the consolidated financial statements.

Reclassifications

Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

Recent Accounting Pronouncements

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have an impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose

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the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of ASU 2016-01 to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company does not expect the adoption of ASU 2016-02 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, “Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting.” Among other things, the amendments in ASU 2016-07, eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The amendments require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company does not expect the adoption of ASU 2016-09 to have a material impact on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning

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after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, “Business Combinations (Topic 805): Clarifying the Definition of a Business”. The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of states and political subdivisions, corporate equity securities, and corporate debt securities. Amortized costs and fair values of securities at December 31, 2016 and 2015 were as follows (in thousands):

	2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$ 81,451	\$ 177	\$ (1,457)	\$ 80,171
Obligations of states and political subdivisions	14,654	146	(180)	14,620
Corporate equity securities	1	10	—	11
Total securities available for sale	<u>\$ 96,106</u>	<u>\$ 333</u>	<u>\$ (1,637)</u>	<u>\$ 94,802</u>
Securities held to maturity:				
U.S. agency and mortgage-backed securities	\$ 37,269	\$ 1	\$ (483)	\$ 36,787
Obligations of states and political subdivisions	14,629	18	(211)	14,436
Corporate debt securities	1,500	—	(14)	1,486
Total securities held to maturity	<u>\$ 53,398</u>	<u>\$ 19</u>	<u>\$ (708)</u>	<u>\$ 52,709</u>
Total securities	<u>\$ 149,504</u>	<u>\$ 352</u>	<u>\$ (2,345)</u>	<u>\$ 147,511</u>

Total securities	<u>\$ 88,423</u>	<u>\$ (824)</u>	<u>\$ 14,462</u>	<u>\$ (414)</u>	<u>\$ 102,885</u>	<u>\$ (1,238)</u>
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The tables above provide information about securities that have been in an unrealized loss position for less than twelve consecutive months and securities that have been in an unrealized loss position for twelve consecutive months or more. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Impairment is considered to be other-than-temporary if the Company (1) intends to sell the security, (2) more likely than not will be required to sell the security before recovering its cost, or (3) does not expect to recover the security's entire amortized cost basis. Presently, the Company does not intend to sell any of these securities, does not expect to be required to sell these securities, and expects to recover the entire amortized cost of all the securities.

At December 31, 2016, there were sixty-four U.S. agency and mortgage-backed securities, fifty obligations of states and political subdivisions, and one corporate debt security in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.7 years at December 31, 2016. At December 31, 2015, there were fifty-two U.S. agency and mortgage-backed securities and thirteen obligations of states and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio was considered investment grade at December 31, 2015. The weighted-average re-pricing term of the portfolio was 4.6 years at December 31, 2015. The unrealized losses at December 31, 2016 in the U.S. agency and mortgage-backed securities portfolio, the obligations of states and political subdivisions portfolio, and the corporate debt securities portfolio were related to changes in market interest rates and not credit concerns of the issuers.

The amortized cost and fair value of securities at December 31, 2016 by contractual maturity are shown below (in thousands). Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties. Corporate equity securities are not included in the maturity categories in the following maturity summary because they do not have a stated maturity date.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$ 471	\$ 473	\$ —	\$ —
Due after one year through five years	10,550	10,520	1,776	1,771
Due after five years through ten years	13,984	13,825	18,174	18,029
Due after ten years	71,100	69,973	33,448	32,909
Corporate equity securities	1	11	—	—
	<u>\$ 96,106</u>	<u>\$ 94,802</u>	<u>\$ 53,398</u>	<u>\$ 52,709</u>

Proceeds from maturities, calls, principal payments, and sales of securities available for sale during 2016 and 2015 were \$22.8 million and \$17.7 million, respectively. Gross gains of \$22 thousand were realized on calls and sales during 2016. There were no gross gains realized on calls and sales during 2015. Gross losses of \$14 thousand and \$55 thousand were realized on calls and sales during 2016 and 2015, respectively.

Proceeds from maturities, calls, and principal payments, and sales of securities held to maturity during 2016 and 2015 were \$12.8 million and \$2.3 million. For the year ended December 31, 2016, the Company sold one security from the held to maturity portfolio. The Company recognized no gain or loss related to the sale as the carrying value of the security sold equaled the proceeds from the sale of \$657 thousand. The sale of this security was in response to credit deterioration of the issuer. There were no sales of securities from the held to maturity portfolio for the year ended December 31, 2015. The Company did not realize any gross gains or gross losses on held to maturity securities during 2016 or 2015.

Securities having a fair value of \$27.7 million and \$26.9 million at December 31, 2016 and 2015 were pledged to secure public deposits and for other purposes required by law.

Federal Home Loan Bank, Federal Reserve Bank and Community Bankers' Bank stock are generally viewed as long-term investments and as restricted securities, which are carried at cost, because there is a minimal market for the stock. Therefore, when evaluating restricted securities for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider these investments to be other-than-temporarily impaired at December 31, 2016, and no impairment has been recognized.

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The composition of restricted securities at December 31, 2016 and 2015 was as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Federal Home Loan Bank stock	\$ 623	\$ 466
Federal Reserve Bank stock	875	875
Community Bankers' Bank stock	50	50
	<u>\$ 1,548</u>	<u>\$ 1,391</u>

Note 3. Loans

Loans at December 31, 2016 and 2015 are summarized as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Real estate loans:		
Construction and land development	\$ 34,699	\$ 33,135
Secured by 1-4 family residential	198,763	189,286
Other real estate	211,210	181,447
Commercial and industrial loans	29,981	24,048
Consumer and other loans	11,414	11,083
Total loans	<u>\$ 486,067</u>	<u>\$ 438,999</u>
Allowance for loan losses	(5,321)	(5,524)
Loans, net	<u>\$ 480,746</u>	<u>\$ 433,475</u>

Net deferred loan fees included in the above loan categories were \$142 thousand at December 31, 2016 and net deferred loan costs included in the above loan categories were \$54 thousand at December 31, 2015. Consumer and other loans included \$264 thousand and \$257 thousand of demand deposit overdrafts at December 31, 2016 and 2015, respectively.

The following tables provide a summary of loan classes and an aging of past due loans as of December 31, 2016 and 2015 (in thousands):

	December 31, 2016							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non- Accrual Loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction and land development	\$ —	\$ 40	\$ —	\$ 40	\$ 34,659	\$ 34,699	\$ 1,033	\$ —
1-4 family residential	980	170	410	1,560	197,203	198,763	413	84
Other real estate loans	321	701	—	1,022	210,188	211,210	74	—
Commercial and industrial	36	309	32	377	29,604	29,981	—	32
Consumer and other loans	19	7	—	26	11,388	11,414	—	—
Total	<u>\$ 1,356</u>	<u>\$ 1,227</u>	<u>\$ 442</u>	<u>\$ 3,025</u>	<u>\$ 483,042</u>	<u>\$ 486,067</u>	<u>\$ 1,520</u>	<u>\$ 116</u>

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	December 31, 2015							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non- Accrual Loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction and land development	\$ —	\$ —	\$ —	\$ —	\$ 33,135	\$ 33,135	\$ 1,269	\$ —
1-4 family residential	635	18	264	917	188,369	189,286	346	—
Other real estate loans	387	358	790	1,535	179,912	181,447	2,145	—
Commercial and industrial	—	—	92	92	23,956	24,048	94	92
Consumer and other loans	20	—	—	20	11,063	11,083	—	—
Total	<u>\$ 1,042</u>	<u>\$ 376</u>	<u>\$ 1,146</u>	<u>\$ 2,564</u>	<u>\$ 436,435</u>	<u>\$ 438,999</u>	<u>\$ 3,854</u>	<u>\$ 92</u>

Credit Quality Indicators

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

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

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

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

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

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

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The following tables provide an analysis of the credit risk profile of each loan class as of December 31, 2016 and 2015 (in thousands):

	December 31, 2016				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 29,416	\$ 2,402	\$ 2,881	\$ —	\$ 34,699
Secured by 1-4 family residential	193,395	3,295	2,073	—	198,763
Other real estate loans	200,009	6,990	4,211	—	211,210
Commercial and industrial	29,456	386	139	—	29,981
Consumer and other loans	11,414	—	—	—	11,414
Total	\$ 463,690	\$ 13,073	\$ 9,304	\$ —	\$ 486,067

	December 31, 2015				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 26,371	\$ 2,587	\$ 4,177	\$ —	\$ 33,135
Secured by 1-4 family residential	182,595	3,376	3,315	—	189,286
Other real estate loans	165,310	9,977	6,160	—	181,447
Commercial and industrial	23,351	432	265	—	24,048
Consumer and other loans	11,083	—	—	—	11,083
Total	\$ 408,710	\$ 16,372	\$ 13,917	\$ —	\$ 438,999

Note 4. Allowance for Loan Losses

The following tables present, as of December 31, 2016 and 2015, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology (in thousands).

	December 31, 2016					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2015	\$ 1,532	\$ 939	\$ 2,534	\$ 306	\$ 213	\$ 5,524
Charge-offs	—	(83)	(165)	—	(540)	(788)
Recoveries	4	293	2	11	275	585
Provision for (recovery of) loan losses	(1,095)	(130)	771	63	391	—
Ending Balance, December 31, 2016	\$ 441	\$ 1,019	\$ 3,142	\$ 380	\$ 339	\$ 5,321
Ending Balance:						
Individually evaluated for impairment	—	37	—	—	—	37
Collectively evaluated for impairment	441	982	3,142	380	339	5,284
Loans:						
Ending Balance	34,699	198,763	211,210	29,981	11,414	486,067
Individually evaluated for impairment	1,973	1,828	984	75	—	4,860
Collectively evaluated for impairment	32,726	196,935	210,226	29,906	11,414	481,207

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

As of December 31, 2016, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$460 thousand. At December 31, 2016, \$300 thousand of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were \$982 thousand in TDRs at December 31, 2015, \$317 thousand of which were performing under the restructured terms. Modified terms under TDRs may include rate reductions, extension of terms that are considered to be below market, conversion to interest only, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. There was one loan secured by 1-4 family residential real estate classified as a TDR during the year ended December 31, 2016 because principal was forgiven as part of the loan modification. The recorded investment for this loan prior to modification totaled \$138 thousand and the recorded investment after the modification totaled \$88 thousand. There were no loans modified under TDRs during the year ended December 31, 2015. The following table provides further information regarding loans modified under TDRs during the year ended December 31, 2016 (dollars in thousands):

	For the year ended December 31, 2016		
	Number of Contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment
Real estate loans:			
Construction	—	\$ —	\$ —
Secured by 1-4 family	1	138	88
Other real estate loans	—	—	—
Commercial and industrial	—	—	—
Consumer and other loans	—	—	—
Total	<u>1</u>	<u>\$ 138</u>	<u>\$ 88</u>

The troubled debt restructuring described above increased the allowance for loan losses by \$32 thousand and resulted in a charge-off of \$50 thousand during the year ended December 31, 2016.

For the years ended December 31, 2016 and 2015, there were no troubled debt restructurings that subsequently defaulted within twelve months of the loan modification. Management defines default as over ninety days past due or the foreclosure and repossession of the collateral or charge-off of the loan during the twelve month period subsequent to the modification.

There were no non-accrual loans excluded from impaired loan disclosure at December 31, 2016 and December 31, 2015. Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income in the amount of \$107 thousand and \$243 thousand during the years ended December 31, 2016 and 2015, respectively.

Note 5. Other Real Estate Owned

Changes in the balance for OREO are as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Balance at the beginning of year, gross	\$ 2,903	\$ 2,263
Transfers in	287	1,664
Charge-offs	(251)	(381)
Sales proceeds	(2,882)	(717)
Gain on disposition	193	74
Balance at the end of year, gross	<u>\$ 250</u>	<u>\$ 2,903</u>
Less: valuation allowance	—	(224)
Balance at the end of year, net	<u>\$ 250</u>	<u>\$ 2,679</u>

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There were no residential real estate properties included in the ending OREO balances above at December 31, 2016. The carrying amounts of residential real estate properties included in the ending OREO balances above totaled \$627 thousand at December 31, 2015. The Bank did not have any consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process as of December 31, 2016.

Changes in the allowance for OREO losses are as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Balance at beginning of year	\$ 224	\$ 375
Provision for losses	27	230
Charge-offs, net	(251)	(381)
Balance at end of year	<u>\$ —</u>	<u>\$ 224</u>

Net expenses applicable to OREO, other than the provision for losses, were \$46 thousand and \$196 thousand for the years ended December 31, 2016 and 2015, respectively.

Note 6. Premises and Equipment

Premises and equipment are summarized as follows at December 31, 2016 and 2015 (in thousands):

	<u>2016</u>	<u>2015</u>
Land	\$ 4,796	\$ 4,974
Buildings and leasehold improvements	18,524	19,390
Furniture and equipment	5,836	11,251
Construction in process	216	20
	<u>\$ 29,372</u>	<u>\$ 35,635</u>
Less accumulated depreciation	8,587	14,246
	<u>\$ 20,785</u>	<u>\$ 21,389</u>

Depreciation expense included in operating expenses for 2016 and 2015 was \$1.4 million and \$1.2 million, respectively.

Note 7. Deposits

The aggregate amount of time deposits, in denominations of \$250 thousand or more, was \$10.1 million and \$10.6 million at December 31, 2016 and 2015, respectively.

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2016 and 2015, brokered deposits totaled \$601 thousand and \$600 thousand, respectively, and were included in time deposits on the Company's consolidated financial statements.

At December 31, 2016, the scheduled maturities of time deposits were as follows (in thousands):

2017	\$ 60,894
2018	24,587
2019	14,505
2020	14,678
2021	12,289
Thereafter	1,474
	<u>\$ 128,427</u>

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Note 8. Other Borrowings

The Bank had unused lines of credit totaling \$125.6 million and \$128.1 million available with non-affiliated banks at December 31, 2016 and 2015, respectively. These amounts primarily consist of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) in which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled \$82.7 million at December 31, 2016. The Bank had collateral pledged on the borrowing line at December 31, 2016 and 2015 including real estate loans totaling \$103.9 million and \$105.1 million, respectively, and FHLB stock with a book value of \$623 thousand and \$466 thousand, respectively. The Bank did not have borrowings from the FHLB at December 31, 2016 and 2015.

Note 9. Subordinated Debt

On October 30, 2015, the Company entered into a Subordinated Loan Agreement (the Agreement) pursuant to which the Company issued an interest only subordinated term note due 2025 in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note qualifies as Tier 2 capital for regulatory capital purposes and at December 31, 2016, the total amount of subordinated debt issued was included in the Company's Tier 2 capital. Unamortized debt issuance costs related to the Note were \$70 thousand and \$87 thousand at December 31, 2016 and 2015, respectively.

The Note has a maturity date of October 1, 2025. Subject to regulatory approval, the Company may prepay the Note, in part or in full, beginning on October 30, 2020. The Note is an unsecured, subordinated obligation of the Company and ranks junior in right of payment to the Company's senior indebtedness and to the Company's obligations to its general creditors. The Note ranks equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the Note. The Note ranks senior to all current and future junior subordinated debt obligations, preferred stock and common stock of the Company.

The Note is not convertible into common stock or preferred stock. The Agreement contains customary events of default such as the bankruptcy of the Company and the non-payment of principal or interest when due. The holder of the Note may accelerate the repayment of the Note only in the event of bankruptcy or similar proceedings and not for any other event of default.

Note 10. Junior Subordinated Debt

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at December 31, 2016 and 2015 was 3.59% and 3.13%, respectively. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the junior subordinated debt.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, \$4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at December 31, 2016 and 2015 was 2.45% and 1.93%, respectively. The securities have a mandatory redemption date of October 1, 2036, and were subject to varying call provisions that began October 1, 2011. The principal asset of Trust III is \$4.1 million of the Company's junior subordinated debt with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the junior subordinated debt.

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the junior subordinated debt 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 junior subordinated debt. The portion of the junior subordinated debt not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At December 31, 2016 and December 31, 2015, the total amount of junior subordinated debt issued by the Trusts was included in the Company's Tier 1 capital.

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Note 11. Income Taxes

The Company is subject to U.S. federal and Virginia income tax as well as bank franchise tax in the state of Virginia. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2013.

Net deferred tax assets consisted of the following components at December 31, 2016 and 2015 (in thousands):

	<u>2016</u>	<u>2015</u>
Deferred Tax Assets		
Allowance for loan losses	\$ 1,809	\$ 1,878
Allowance for other real estate owned	—	76
Unfunded pension liability	—	719
Gain on other real estate owned	—	672
Securities available for sale	447	102
Accrued pension	689	568
Core deposit intangible	371	179
Unvested stock-based compensation	19	11
Limited partnership investments	17	—
Loan origination fees, net	48	—
	<u>\$ 3,400</u>	<u>\$ 4,205</u>
Deferred Tax Liabilities		
Depreciation	\$ 708	\$ 693
Discount accretion	2	2
Loan origination costs, net	—	18
	<u>\$ 710</u>	<u>\$ 713</u>
Net deferred tax assets	<u>\$ 2,690</u>	<u>\$ 3,492</u>

The income tax expense for the years ended December 31, 2016 and 2015 consisted of the following (in thousands):

	<u>2016</u>	<u>2015</u>
Current tax expense	\$ 1,925	\$ 822
Deferred tax expense	428	134
	<u>\$ 2,353</u>	<u>\$ 956</u>

The income tax expense differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2016 and 2015, due to the following (in thousands):

	<u>2016</u>	<u>2015</u>
Computed tax expense at statutory federal rate	\$ 2,808	\$ 1,227
Decrease in income taxes resulting from:		
Tax-exempt interest and dividend income	(254)	(201)
Other	(201)	(70)
	<u>\$ 2,353</u>	<u>\$ 956</u>

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Note 12. Funds Restrictions and Reserve Balance

Transfers of funds from the banking subsidiary to the parent company in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. At December 31, 2016, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company, without prior regulatory approval, totaled \$1.9 million. The amount of unrestricted funds is determined by subtracting the total dividend payments of the Bank from the Bank's net income for that year, combined with the Bank's retained net income for the preceding two years. Beginning on January 1, 2017, the Bank could not transfer funds to the Company without prior approval from regulatory authorities under current supervisory practices.

The Bank must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final weekly reporting period in the years ended December 31, 2016 and 2015, the aggregate amounts of daily average required balances were approximately \$6.0 million and \$5.6 million, respectively.

Note 13. Benefit Plans

Pension Plan

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. Effective May 1, 2011, the plan was frozen to new participants. Only individuals employed on or before April 30, 2011 were eligible to become participants in the plan upon satisfaction of the eligibility requirements. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank's funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

On September 14, 2016, the defined benefit pension plan was amended to be terminated and the amendment has been submitted to the Internal Revenue Service and the Pension Benefit Guarantee Corporation for approval. Under the amendment, benefit accruals ceased as of November 30, 2016. Although an application for termination approval is in process, the date of possible Internal Revenue Service approval is unknown and there can be no assurance of when the plan will be terminated. The funding status of the plan upon termination is not expected to be significantly different from the funded status disclosed in the table below. The benefit obligation is not expected to change at termination and the fair value of assets at termination is not expected to change significantly at termination as the assets are expected to remain in the cash and equivalents category through the termination date.

The following tables provide a reconciliation of the changes in the plan benefit obligation and the fair value of assets for the periods ended December 31, 2016 and 2015 (in thousands).

	<u>2016</u>	<u>2015</u>
Change in Benefit Obligation		
Benefit obligation, beginning of year	\$ 8,107	\$ 7,729
Service cost	410	446
Interest cost	331	302
Actuarial loss (gain)	245	(271)
Benefits paid	(695)	(99)
Gain due to curtailment	(2,621)	—
Benefit obligation, end of year	<u>\$ 5,777</u>	<u>\$ 8,107</u>
Changes in Plan Assets		
Fair value of plan assets, beginning of year	\$ 4,264	\$ 4,368
Actual return on plan assets	124	(5)
Benefits paid	(695)	(99)
Fair value of assets, end of year	<u>\$ 3,693</u>	<u>\$ 4,264</u>
Funded Status, end of year	<u>\$ (2,084)</u>	<u>\$ (3,843)</u>
Amount Recognized in Other Liabilities	<u><u>\$ (2,084)</u></u>	<u><u>\$ (3,843)</u></u>

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	<u>2016</u>	<u>2015</u>
Amounts Recognized in Accumulated Other Comprehensive Loss, net of tax		
Net loss	\$—	\$2,115
Deferred income tax benefit	—	(719)
Amount recognized	<u>\$—</u>	<u>\$1,396</u>
Weighted Average Assumptions Used to Determine Benefit Obligation		
Discount rate used for disclosure		
First five years	1.47 %	4.25 %
Five years to twenty years	3.34 %	4.25 %
After twenty years	4.30 %	4.25 %
Expected return on plan assets	7.50 %	7.50 %
Rate of compensation increase	3.00 %	3.00 %
Components of Net Periodic Benefit Cost		
Service cost	\$410	\$446
Interest cost	331	302
Expected return on plan assets	(297)	(314)
Recognized net gain due to curtailment	(173)	—
Recognized net actuarial loss	84	86
Net periodic benefit cost	<u>\$355</u>	<u>\$520</u>
Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income (Loss)		
Net gain	\$(2,115)	\$(38)
Total recognized in other comprehensive income (loss)	<u>\$(2,115)</u>	<u>\$(38)</u>
Total Recognized in Net Periodic Benefit Cost and Other Comprehensive Income (Loss)	<u>\$ (1,760)</u>	<u>\$482</u>
Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost		
Discount rate	4.25 %	4.00 %
Expected return on plan assets	7.50 %	7.50 %
Rate of compensation increase	3.00 %	3.00 %

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience, which may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

The process used to select the discount rate assumption takes into account the benefit cash flow and the segmented yields on high-quality corporate bonds that would be available to provide for the payment of the benefit cash flow. A single effective discount rate, rounded to the nearest .25%, is then established that produces an equivalent discounted present value.

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The pension plan's weighted-average asset allocations at the end of the plan year for 2016 and 2015, by asset category were as follows:

Asset Category	<u>2016</u>	<u>2015</u>
Mutual funds - fixed income	—	40 %
Mutual funds - equity	—	60 %
Cash and equivalents	100 %	—
Total	<u>100 %</u>	<u>100 %</u>

It is the responsibility of the trustee to administer the investments of the trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the trust.

Following is a description of the valuation methodologies used for assets measured at fair value.

Fixed income and equity funds: Valued at the net asset value of shares held at year-end.

The pension financial instruments measured and reported at fair value are classified and disclosed in one of the following categories:

- 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.

The following tables set forth by level, within the fair value hierarchy, the Company's pension plan assets at fair value as of December 31, 2016 and 2015 (in thousands):

Fair Value Measurements at December 31, 2016				
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash and equivalents	\$ 3,693	\$ 3,693	\$ —	\$ —
Total	<u>\$ 3,693</u>	<u>\$ 3,693</u>	<u>\$ —</u>	<u>\$ —</u>
Fair Value Measurements at December 31, 2015				
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Fixed income funds	\$ 1,720	\$ 1,720	\$ —	\$ —
Equity funds	2,544	2,544	—	—
Total	<u>\$ 4,264</u>	<u>\$ 4,264</u>	<u>\$ —</u>	<u>\$ —</u>

The Company did not make a cash contribution during the years ended December 31, 2016 and 2015. The Company expects to make a contribution of \$2.1 million upon termination. The accumulated benefit obligation for the defined benefit pension plan was \$5.8 million and \$5.6 million at December 31, 2016 and 2015, respectively.

Estimated future benefit payments, which reflect expected future service, as appropriate, were as follows at December 31, 2016 (in thousands):

2017	\$ 369
2018	5,408
2019	—
2020	—
2021	—
Years 2022-2026	—

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401(k) Plan

The Company maintains a 401(k) plan for all eligible employees. Participating employees may elect to contribute up to the maximum percentage allowed by the Internal Revenue Service, as defined in the plan. The Company makes matching contributions, on a dollar-for-dollar basis, for the first one percent of an employee's compensation contributed to the Plan and fifty cents for each dollar of the employee's contribution between two percent and six percent. The Company also makes an additional contribution based on years of service to participants who have completed at least one thousand hours of service during the year and who are employed on the last day of the Plan Year. All employees who are age nineteen or older are eligible. Employee contributions vest immediately. Employer matching contributions vest after two plan service years with the Company. The Company has the discretion to make a profit sharing contribution to the plan each year based on overall performance, profitability, and other economic factors. For the years ended December 31, 2016 and 2015, expense attributable to the Plan amounted to \$482 thousand and \$451 thousand, respectively.

Employee Stock Ownership Plan

On January 1, 2000, the Company established an employee stock ownership plan. The ESOP provides an opportunity for the Company to award shares of First National Corporation stock to employees at its discretion. Employees are eligible to participate in the ESOP effective immediately upon beginning service with the Company. Participants become 100% vested after two years of credited service. The Board of Directors may make discretionary contributions, within certain limitations prescribed by federal tax regulations. There was no compensation expense for the ESOP for the years ended December 31, 2016 and 2015. Shares of the Company held by the ESOP at December 31, 2016 and 2015 were 247,283 and 208,168, respectively.

On September 14, 2016, the ESOP was amended to freeze the plan to new participants and to cease all contributions, effective December 31, 2016. The amendment also directs matching contributions and certain other retirement contributions made by the Company to the 401(k) plan. The ESOP shall be maintained as a frozen plan and continue to be invested in Company stock and such other assets as permitted under the ESOP and Trust Agreement for the benefit of participants and their beneficiaries.

Note 14. Earnings per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

The following table presents the computation of basic and diluted earnings per share for the years ended December 31, 2016 and 2015 (dollars in thousands, except per share data):

	<u>2016</u>	<u>2015</u>
(Numerator):		
Net income	\$ 5,907	\$ 2,655
Effective dividend on preferred stock	—	1,113
Net income available to common shareholders	<u>\$ 5,907</u>	<u>\$ 1,542</u>
(Denominator):		
Weighted average shares outstanding – basic	4,924,636	4,910,608
Potentially dilutive common shares – restricted stock units	3,548	2,566
Weighted average shares outstanding – diluted	<u>4,928,184</u>	<u>4,913,174</u>
Income per common share		
Basic	\$ 1.20	\$ 0.31
Diluted	\$ 1.20	\$ 0.31

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Note 15. Commitments and Unfunded Credits

The Company, through its banking subsidiary 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.

At December 31, 2016 and 2015, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	<u>2016</u>	<u>2015</u>
Commitments to extend credit and unfunded commitments under lines of credit	\$ 71,421	\$ 61,115
Stand-by letters of credit	8,983	7,732

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

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and usually do not contain a specified maturity date and may 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. 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 December 31, 2016, the Bank had \$10.1 million in locked-rate commitments to originate mortgage loans and \$337 thousand in loans held for sale. 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.

The Bank has cash accounts in other commercial banks. The amount on deposit at these banks at December 31, 2016 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$17 thousand.

Note 16. Transactions with Related Parties

During the year, executive officers and directors (and companies controlled by them) were customers of and had transactions with the Company in the normal course of business. In management's opinion, these transactions were made on substantially the same terms as those prevailing for other customers.

At December 31, 2016 and 2015, these loans totaled \$148 thousand and \$593 thousand, respectively. During 2016, total principal additions were \$165 thousand and total principal payments were \$17 thousand. Adjustments to related party loan balances during 2016 due to transition of related parties totaled approximately \$593 thousand.

Deposits from related parties held by the Bank at December 31, 2016 and 2015 amounted to \$5.6 million and \$7.5 million, respectively.

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Note 17. Lease Commitments

The Company was obligated under noncancelable leases for banking premises. Total rental expense for operating leases for 2016 and 2015 was \$90 thousand and \$112 thousand, respectively. Minimum rental commitments under noncancelable leases with terms in excess of one year as of December 31, 2016 were as follows (in thousands):

	Operating Leases
2017	\$ 87
2018	65
2019	23
2020	5
2021 and thereafter	—
	<u>\$ 180</u>

Note 18. Dividend Reinvestment Plan

The Company has in effect a Dividend Reinvestment Plan (DRIP) which provides an automatic conversion of dividends into common stock for enrolled shareholders. The Company may issue common shares to the DRIP or purchase on the open market. Common shares are purchased at a price which is based on the average closing prices of the shares as quoted on the Over-the-Counter Markets Group exchange for the 10 business days immediately preceding the dividend payment date.

The Company issued 3,949 and 4,109 common shares to the DRIP during the years ended December 31, 2016 and 2015, respectively.

Note 19. Fair Value Measurements

Determination of Fair Value

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

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

Fair Value Hierarchy

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

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

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- Level 2 – Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3 – Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires a significant management judgment or estimation.

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

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

Securities available for sale

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

The following tables present the balances of assets measured at fair value on a recurring basis as of December 31, 2016 and 2015 (in thousands).

<u>Description</u>	Balance as of December 31, 2016	Fair Value Measurements at December 31, 2016		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 80,171	\$ —	\$ 80,171	\$ —
Obligations of states and political subdivisions	14,620	—	14,620	—
Corporate equity securities	11	11	—	—
	<u>\$ 94,802</u>	<u>\$ 11</u>	<u>\$ 94,791</u>	<u>\$ —</u>
<u>Description</u>	Balance as of December 31, 2015	Fair Value Measurements at December 31, 2015		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 89,337	\$ —	\$ 89,337	\$ —
Obligations of states and political subdivisions	16,214	—	16,214	—
Corporate equity securities	8	8	—	—
	<u>\$ 105,559</u>	<u>\$ 8</u>	<u>\$ 105,551</u>	<u>\$ —</u>

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

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

Loans held for sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the years ended December 31, 2016 and 2015.

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. The measurement of loss associated with impaired loans can be based on the present value of expected future cash flows discounted at the loan's effective interest rate, the observable market price of the loan, or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2) within the last twelve months. However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for (or recovery of) loan losses on the Consolidated Statements of Income.

Other real estate owned

Loans are transferred to other real estate owned when the collateral securing them is foreclosed on or acquired through a deed in lieu of foreclosure. The measurement of loss associated with other real estate owned is based on the appraisal documents and assessed the same way as impaired loans described above. Any fair value adjustments are recorded in the period incurred as other real estate owned expense on the Consolidated Statements of Income.

The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis as of December 31, 2016 and 2015 (dollars in thousands).

<u>Description.</u>	Balance as of December 31, 2016	Fair Value Measurements at December 31, 2016		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 116	\$ —	\$ —	\$ 116
Other real estate owned, net	250	—	—	250

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Description	Fair Value Measurements at December 31, 2015			
	Balance as of December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 377	\$ —	\$ —	\$ 377
Other real estate owned, net	2,679	—	—	2,679

Quantitative information about Level 3 Fair Value Measurements for December 31, 2016				
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 116	Property appraisals	Selling cost	10 %
Other real estate owned, net	\$ 250	Property appraisals	Selling cost	0 %

The amount disclosed as fair value of other real estate owned at December 31, 2016 represents the carrying value of the property. Since the appraised value of the property, net of selling costs, exceeded the Company's carrying value on the date the property was transferred from premises and equipment to other real estate owned, the Company did not adjust the carrying value for selling costs.

Quantitative information about Level 3 Fair Value Measurements for December 31, 2015				
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 377	Property appraisals	Selling cost	2-10% (5%)
Other real estate owned, net	\$ 2,679	Property appraisals	Selling cost	7%

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

Cash and Cash Equivalents and Federal Funds Sold

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

Securities Held to Maturity

Certain debt securities that management has the positive intent and ability to hold until maturity are recorded at amortized cost. Fair values are determined in a manner that is consistent with securities available for sale.

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Restricted Securities

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

Loans

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

Deposit Liabilities

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

Accrued Interest

Accrued interest receivable and payable were estimated to equal the carrying value due to the short-term nature of these financial instruments.

Borrowings and Federal Funds Purchased

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

Bank Owned Life Insurance

Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of these policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

Commitments and Unfunded Credits

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

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2016 and 2015, fair value of loan commitments and standby letters of credit was immaterial.

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The carrying values and estimated fair values of the Company's financial instruments at December 31, 2016 and 2015 are as follows (in thousands):

Fair Value Measurements at December 31, 2016 Using					
Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value	
Financial Assets					
Cash and short-term investments	\$ 41,092	\$ 41,092	\$ —	\$ —	\$ 41,092
Securities available for sale	94,802	11	94,791	—	94,802
Securities held to maturity	53,398	—	51,223	1,486	52,709
Restricted securities	1,548	—	1,548	—	1,548
Loans held for sale	337	—	337	—	337
Loans, net	480,746	—	—	481,475	481,475
Bank owned life insurance	13,928	—	13,928	—	13,928
Accrued interest receivable	1,746	—	1,746	—	1,746
Financial Liabilities					
Deposits	\$ 645,570	\$ —	\$ 517,143	\$ 127,179	\$ 644,322
Subordinated debt	4,930	—	—	4,715	4,715
Junior subordinated debt	9,279	—	—	9,075	9,075
Accrued interest payable	95	—	95	—	95
Fair Value Measurements at December 31, 2015 Using					
Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value	
Financial Assets					
Cash and short-term investments	\$ 39,334	\$ 39,334	\$ —	\$ —	\$ 39,334
Securities available for sale	105,559	8	105,551	—	105,559
Securities held to maturity	66,519	—	64,938	1,500	66,438
Restricted securities	1,391	—	1,391	—	1,391
Loans held for sale	323	—	323	—	323
Loans, net	433,475	—	—	438,392	438,392
Bank owned life insurance	11,742	—	11,742	—	11,742
Accrued interest receivable	1,661	—	1,661	—	1,661
Financial Liabilities					
Deposits	\$ 627,116	\$ —	\$ 486,015	\$ 140,306	\$ 626,321
Subordinated debt	4,913	—	—	4,913	4,913
Junior subordinated debt	9,279	—	—	8,141	8,141
Accrued interest payable	117	—	117	—	117

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

Note 20. Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective January 1, 2015, with full compliance of all the requirements being phased in over a multi-year schedule, and becoming fully phased in by January 1, 2019. As part of the new requirements, the common equity Tier 1 capital ratio is calculated and utilized in the assessment of capital for all institutions. The final rules also established a "capital conservation buffer" above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years, which began on January 1, 2016.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total (as defined in the regulations), Tier 1 (as defined), and common equity Tier 1 capital (as defined) to risk-weighted assets (as defined), and of Tier 1 capital to average assets. Management believes, as of December 31, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2016, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum risk-based capital and leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

A comparison of the capital of the Bank at December 31, 2016 and December 31, 2015 with the minimum regulatory guidelines were as follows (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016:						
Total Capital (to Risk-Weighted Assets)	\$ 65,590	13.47 %	\$ 38,951	8.00 %	\$ 48,689	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)	\$ 60,269	12.38 %	\$ 29,213	6.00 %	\$ 38,951	8.00 %
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 60,269	12.38 %	\$ 21,910	4.50 %	\$ 31,648	6.50 %
Tier 1 Capital (to Average Assets)	\$ 60,269	8.48 %	\$ 28,432	4.00 %	\$ 35,540	5.00 %
December 31, 2015:						
Total Capital (to Risk-Weighted Assets)	\$ 61,513	13.86 %	\$ 35,497	8.00 %	\$ 44,372	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)	\$ 55,989	12.62 %	\$ 26,623	6.00 %	\$ 35,497	8.00 %
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 55,989	12.62 %	\$ 19,967	4.50 %	\$ 28,842	6.50 %
Tier 1 Capital (to Average Assets)	\$ 55,989	8.12 %	\$ 27,571	4.00 %	\$ 34,464	5.00 %

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In addition to the regulatory minimum risk-based capital amounts presented above, the Bank must maintain a capital conservation buffer as required by the Basel III final rules. The buffer began applying to the Bank on January 1, 2016, and is subject to phase-in from 2016 to 2019 in equal annual installments of 0.625%. Accordingly, at December 31, 2016, the Bank was required to maintain a capital conservation buffer of 0.625%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. As of December 31, 2016, the capital conservation buffer of the Bank was 5.47%.

Note 21. Accumulated Other Comprehensive Loss

Changes in each component of accumulated other comprehensive loss were as follows (in thousands):

	Net Unrealized Losses on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
Balance at December 31, 2014	\$ (133)	\$ (1,421)	\$ (1,554)
Unrealized holding losses (net of tax, (\$50))	(95)	—	(95)
Reclassification adjustment (net of tax, (\$19))	36	—	36
Pension liability adjustment (net of tax, \$13)	—	25	25
Change during period	<u>(59)</u>	<u>25</u>	<u>(34)</u>
Balance at December 31, 2015	\$ (192)	\$ (1,396)	\$ (1,588)
Unrealized holding losses (net of tax, (\$341))	(663)	—	(663)
Reclassification adjustment (net of tax, (\$3))	(5)	—	(5)
Pension liability adjustment (net of tax, \$719)	—	1,396	1,396
Change during period	<u>(668)</u>	<u>1,396</u>	<u>728</u>
Balance at December 31, 2016	<u>\$ (860)</u>	<u>\$ —</u>	<u>\$ (860)</u>

The following table presents information related to reclassifications from accumulated other comprehensive income (loss) for the years ended December 31, 2016 and 2015 (in thousands):

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss		Affected Line Item in the Consolidated Statements of Income
	For the year ended December 31,		
	<u>2016</u>	<u>2015</u>	
Securities available for sale:			
Net securities (gains) losses reclassified into earnings	\$ (8)	\$ 55	Net gains (losses) on calls and sales of securities available for sale
Related income tax expense (benefit)	3	(19)	Income tax expense
Total reclassifications	<u>\$ (5)</u>	<u>\$ 36</u>	Net of tax

Note 22. Preferred Stock

On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A at par for \$13.9 million and all 695 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series B at par for \$695 thousand.

Prior to redemption, the Company had (i) 13,900 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Preferred Stock) and (ii) 695 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series B, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Warrant Preferred Stock). The Preferred Stock paid cumulative dividends at a rate of 5% per annum until May 14, 2014, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock paid cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock was fully amortized over a five year period through March 12, 2014, using the constant effective yield method.

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Note 23. Stock Compensation Plans

On May 13, 2014, the Company's shareholders approved the First National Corporation 2014 Stock Incentive Plan, which makes available up to 240,000 shares of common stock for the granting of stock options, restricted stock awards, stock appreciation rights and other stock-based awards. Awards are made at the discretion of the Board of Directors and compensation cost equal to the fair value of the award is recognized over the vesting period.

Stock Awards

Whenever the Company deems it appropriate to grant a stock award, the recipient receives a specified number of unrestricted shares of employer stock. Stock awards may be made by the Company at its discretion without cash consideration and may be granted as settlement of a performance-based compensation award.

During 2016, the Company granted and issued 2,100 shares of common stock to members of the Board of Directors for their dedicated service and support. Compensation expense related to stock awards totaled \$25 thousand and \$28 thousand for the years ended December 31, 2016 and 2015, respectively.

Restricted Stock Units

Restricted stock units are an award of units that correspond in number and value to a specified number of shares of employer stock which the recipient receives according to a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with the employer for a particular length of time. Each restricted stock unit that vests entitles the recipient to receive one share of common stock on a specified issuance date.

In 2016, 9,130 restricted stock units were granted to employees, with 3,047 units vesting immediately and 6,083 units subject to a two year vesting schedule with one half of the units vesting each year on the grant date anniversary. The recipient does not have any stockholder rights, including voting, dividend or liquidation rights, with respect to the shares underlying awarded restricted stock units until vesting has occurred and the recipient becomes the record holder of those shares. The unvested restricted stock units will vest on the established schedule if the employees remain employed by the Company on future vesting dates.

A summary of the activity for the Company's restricted stock units for the period indicated is presented in the following table:

	2016	
	Shares	Weighted Average Grant Date Fair Value
Balance at January 1, 2016	<u>8,353</u>	<u>\$ 9.00</u>
Granted	9,130	8.80
Vested	(7,224)	8.92
Forfeited	—	—
Balance at December 31, 2016	<u><u>10,259</u></u>	<u><u>\$ 8.88</u></u>

At December 31, 2016, based on restricted stock unit awards outstanding at that time, the total unrecognized pre-tax compensation expense related to unvested restricted stock unit awards was \$34 thousand. This expense is expected to be recognized through 2018. Compensation expense related to restricted stock unit awards recognized for the years ended December 31, 2016 and 2015 totaled \$88 thousand and \$71 thousand, respectively. As of December 31, 2016, the Company does not expect the forfeiture of any unvested restricted stock units.

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Note 24. Acquisition

On April 17, 2015, the Bank completed its acquisition of six branch banking operations located in Virginia from Bank of America, National Association (the Acquisition). The Bank paid cash of \$6.6 million for the deposits and premises and equipment. The Bank acquired all related premises and equipment valued at \$4.5 million and assumed \$186.8 million of deposit liabilities. No loans were acquired in the transaction.

The transaction was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration exchanged were recorded at estimated fair values on the acquisition date. The Bank engaged third party specialists to assist in valuing certain assets, including the real estate, core deposit intangible, and goodwill (bargain purchase gain) that resulted from the Acquisition.

The following table provides an assessment of the consideration transferred, assets purchased, and the liabilities assumed (in thousands):

	<u>As Recorded by Bank of America</u>	<u>Fair Value and Other Merger Related Adjustments</u>	<u>As Recorded by the Company</u>
Consideration paid:			
Cash paid			\$ 6,618
Total consideration			<u>\$ 6,618</u>
Assets acquired:			
Cash and cash equivalents	\$ 186,119	\$ —	\$ 186,119
Premises and equipment, net	2,165	2,330	4,495
Other assets	114	—	114
Core deposit intangibles	—	2,910	2,910
Total assets acquired	<u>\$ 188,398</u>	<u>\$ 5,240</u>	<u>\$ 193,638</u>
Liabilities assumed:			
Deposits	\$ 186,119	\$ 683	\$ 186,802
Other liabilities	17	—	17
Total liabilities assumed	<u>\$ 186,136</u>	<u>\$ 683</u>	<u>\$ 186,819</u>
Net identifiable assets acquired over liabilities assumed	<u>\$ 2,262</u>	<u>\$ 4,557</u>	<u>\$ 6,819</u>
Goodwill (bargain purchase gain)			<u>\$ (201)</u>

The bargain purchase gain from the transaction may have resulted from Bank of America's decision to no longer operate bank branches in certain markets and their willingness to sell the related premises and equipment lower than fair value.

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Note 25. Parent Company Only Financial Statements

FIRST NATIONAL CORPORATION

(Parent Company Only)

Balance Sheets

December 31, 2016 and 2015

(in thousands)

	<u>2016</u>	<u>2015</u>
Assets		
Cash	\$ 5,690	\$ 4,412
Investment in subsidiaries, at cost, plus undistributed net income	60,344	55,334
Other assets	335	408
Total assets	<u>\$ 66,369</u>	<u>\$ 60,154</u>
Liabilities and Shareholders' Equity		
Subordinated debt	\$ 4,930	\$ 4,913
Junior subordinated debt	9,279	9,279
Other liabilities	9	9
Total liabilities	<u>\$ 14,218</u>	<u>\$ 14,201</u>
Preferred stock	\$ —	\$ —
Common stock	6,162	6,145
Surplus	7,093	6,956
Retained earnings	39,756	34,440
Accumulated other comprehensive loss, net	(860)	(1,588)
Total shareholders' equity	<u>\$ 52,151</u>	<u>\$ 45,953</u>
Total liabilities and shareholders' equity	<u>\$ 66,369</u>	<u>\$ 60,154</u>

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FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Income
Years Ended December 31, 2016 and 2015
(in thousands)

	<u>2016</u>	<u>2015</u>
Income		
Dividends from subsidiary	\$ 2,325	\$ 13,500
Total income	<u>\$ 2,325</u>	<u>\$ 13,500</u>
Expense		
Interest expense	\$ 620	\$ 286
Supplies	2	17
Legal and professional fees	104	78
Data processing	61	60
Management fee-subsiary	258	250
Other expense	17	21
Total expense	<u>\$ 1,062</u>	<u>\$ 712</u>
Income before allocated tax benefits and undistributed income of subsidiary	\$ 1,263	\$ 12,788
Allocated income tax benefit	<u>361</u>	<u>242</u>
Income before equity in undistributed income of subsidiary	\$ 1,624	\$ 13,030
Equity in undistributed (distributed) income of subsidiary	<u>4,283</u>	<u>(10,375)</u>
Net income	<u>\$ 5,907</u>	<u>\$ 2,655</u>
Effective dividend on preferred stock	<u>—</u>	<u>1,113</u>
Net income available to common shareholders	<u>\$ 5,907</u>	<u>\$ 1,542</u>

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FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2016 and 2015
(in thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities		
Net income	\$ 5,907	\$ 2,655
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed (income) loss of subsidiary	(4,283)	10,375
Amortization of debt issuance costs	17	3
Decrease in other assets	74	279
Increase in other liabilities	—	1
Net cash provided by operating activities	<u>\$ 1,715</u>	<u>\$ 13,313</u>
Cash Flows from Financing Activities		
Proceeds from subordinated debt, net of issuance costs	\$ —	\$ 4,910
Cash dividends paid on common stock, net of reinvestment	(550)	(454)
Cash dividends paid on preferred stock	—	(1,281)
Net proceeds from issuance of common stock	113	99
Repurchase of common stock	—	(1)
Redemption of preferred stock	—	(14,595)
Net cash used in financing activities	<u>\$ (437)</u>	<u>\$ (11,322)</u>
Increase in cash and cash equivalents	\$ 1,278	\$ 1,991
Cash and Cash Equivalents		
Beginning	4,412	2,421
Ending	<u>\$ 5,690</u>	<u>\$ 4,412</u>

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

The Company's management has evaluated, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of disclosure controls and procedures as of December 31, 2016 pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2016, the disclosure controls and procedures are effective in ensuring that the information required to be disclosed in Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner and (2) accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Refer to Item 8 of this report for the "Management's Report on the Effectiveness of Internal Controls 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 is reasonably likely to materially affect, internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information required by this Item is set forth under the headings "Election of Directors – Nominees," "Executive Officers Who Are Not Directors," "Section 16(a) Beneficial Ownership Reporting Compliance," "Code of Conduct and Ethics," "Committees" and "Director Selection Process" in the Company's Proxy Statement for the 2017 Annual Meeting of Shareholders (the Proxy Statement), which information is incorporated herein by reference.

Item 11. Executive Compensation

Information required by this Item is set forth under the headings "Executive Compensation" and "Director Compensation" in the Proxy Statement, which information is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this Item is set forth under the heading "Stock Ownership of Directors and Executive Officers" and "Stock Ownership of Certain Beneficial Owners" in the Proxy Statement, which information is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this Item is set forth under the headings "Certain Relationships and Related Party Transactions" and "Director Independence" in the Proxy Statement, which information is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

Information required by this Item is set forth under the headings "Auditor Fees and Services" and "Policy for Approval of Audit and Permitted Non-Audit Services" in the Proxy Statement, which information is incorporated herein by reference.

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PART IV

Item 15. Exhibits, Financial Statement Schedules

- (a) (1) The response to this portion of Item 15 is included in Item 8 above.
- (2) The response to this portion of Item 15 is included in Item 8 above.
- (3) The following documents are attached hereto or incorporated herein by reference to Exhibits:
- 2.1 Purchase and Assumption Agreement, dated as of November 18, 2014, between Bank of America, National Association and First Bank (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on November 19, 2014).
 - 3.1 Amended and Restated Articles of Incorporation, as amended and restated on March 3, 2009 (incorporated herein by reference to Exhibit 3.1 to the Company's Form 10-K for the year ended December 31, 2008).
 - 3.2 Articles of Amendment to the Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on March 17, 2009).
 - 3.3 By-laws of First National Corporation (as restated in electronic format as of May 11, 2015), attached as Exhibit 3.1 to the Current Report on Form 8-K filed May 15, 2015 and incorporated by reference herein.
 - 4.1 Specimen of Common Stock Certificate (incorporated herein by reference to Exhibit 1 to the Company's Form 10 filed with SEC on May 2, 1994).
 - 4.2 Form of Certificate for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the SEC on March 17, 2009).
 - 4.3 Form of Certificate for Fixed Rate Cumulative Perpetual Preferred Stock, Series B (incorporated herein by reference to Exhibit 4.3 to the Company's Current Report on Form 8-K filed with the SEC on March 17, 2009).
 - 10.1 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and Dennis A. Dysart (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q for the quarter ended September 30, 2007).
 - 10.2 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and M. Shane Bell (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarter ended June 30, 2007).
 - 10.3 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and Marshall J. Beverley, Jr. (incorporated by reference to Exhibit 10.3 to the Company's Form 10-Q for the quarter ended June 30, 2007).
 - 10.4 Amendment to Employment Agreement between the Company and Dennis A. Dysart and M. Shane Bell (incorporated by reference to Exhibit 10.6 to the Company's Form 10-K for the year ended December 31, 2008).
 - 10.5 Amendment to Employment Agreement between the Company and Marshall J. Beverley, Jr. (incorporated by reference to Exhibit 10.7 to the Company's Form 10-K for the year ended December 31, 2008).
 - 10.8 Employment Agreement between the Company and Scott C. Harvard (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on May 22, 2014).
 - 10.9 Executive Incentive Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on March 19, 2013).

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- 10.10 2014 Stock Incentive Plan (incorporated by reference to Exhibit 99.1 to the Company's Registration Statement on Form S-8, filed February 11, 2015).
 - 10.11 Form of Restricted Stock Unit (incorporated herein by reference to Exhibit 10.1 to the Company's Form 10-Q for the quarter ended March 31, 2015).
 - 10.12 Subordinated Loan Agreement, dated October 30, 2015, between First National Corporation and Community Funding CLO, Ltd. (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on November 5, 2015).
 - 14.1 Code of Conduct and Ethics (incorporated herein by reference to Exhibit 14.1 to the Company's Current Report on Form 8-K, filed on April 11, 2008).
 - 21.1 Subsidiaries of the Company.
 - 23.1 Consent of Yount, Hyde & Barbour, P.C.
 - 31.1 Certification of Chief Executive Officer, Section 302 Certification.
 - 31.2 Certification of Chief Financial Officer, Section 302 Certification.
 - 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.
 - 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.
 - 101 The following materials from First National Corporation's Annual Report on Form 10-K for the year ended December 31, 2016 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Cash Flows, (v) Consolidated Statements of Changes in Shareholders' Equity, and (vi) Notes to Consolidated Financial Statements.
- (b) Exhibits
See Item 15(a)(3) above.
- (c) Financial Statement Schedules
See Item 15(a)(2) above.

Item 16. Form 10-K Summary

Not required.

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EXHIBIT INDEX

<u>Number</u>	<u>Document</u>
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