FIRST NATIONAL CORP /VA/
Form 10-Q
May 15, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2012

or

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

For the transition period from to

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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

(540) 465-9121

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. As of May 11, 2012, 2,955,649 shares of common stock, par value $1.25 per share, of the registrant were outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements
FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

(in thousands, except share and per share data)

	(unaudited) March 31, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 9,477	$ 6,314
Interest-bearing deposits in banks	19,553	23,210
Securities available for sale, at fair value	84,627	91,665
Restricted securities, at cost	2,775	2,775
Loans held for sale	329	274
Loans, net of allowance for loan losses, 2012, $13,636, 2011, $12,937	376,758	379,503
Other real estate owned, net of valuation allowance, 2012, $2,455, 2011, $2,792	5,562	6,374
Premises and equipment, net	19,446	19,598
Interest receivable	1,523	1,620
Other assets	8,193	7,731
Total assets	$ 528,243	$ 539,064
Liabilities and Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 85,043	$ 81,714
Savings and interest-bearing demand deposits	204,682	198,194
Time deposits	174,870	189,264
Total deposits	$ 464,595	$ 469,172
Other borrowings	14,094	19,100
Trust preferred capital notes	9,279	9,279
Other liabilities	4,131	4,417
Total liabilities	$ 492,099	$ 501,968
Shareholders Equity		
Preferred stock, $1,000 liquidation preference; 14,595 shares issued and outstanding	$ 14,299	$ 14,263
Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2012 and 2011, 2,955,649 shares	3,695	3,695
Surplus	1,644	1,644

Retained earnings	16,753	16,503
Accumulated other comprehensive income (loss), net	(247)	991
Total shareholders equity	$ 36,144	$ 37,096
Total liabilities and shareholders equity	$ 528,243	$ 539,064

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

Three months ended March 31, 2012 and 2011

(in thousands, except per share data)

	(unaudited) March 31, 2012	(unaudited) March 31, 2011
Interest and Dividend Income		
Interest and fees on loans	$ 5,547	$ 5,833
Interest on federal funds sold	3	7
Interest on deposits in banks	3	7
Interest and dividends on securities available for sale:		
Taxable interest	535	451
Tax-exempt interest	102	123
Dividends	18	17
Total interest and dividend income	$ 6,208	$ 6,438
Interest Expense		
Interest on deposits	$ 986	$ 1,303
Interest on trust preferred capital notes	62	109
Interest on other borrowings	80	91
Total interest expense	$ 1,128	$ 1,503
Net interest income	$ 5,080	$ 4,935
Provision for loan losses	2,000	270
Net interest income after provision for loan losses	$ 3,080	$ 4,665
Noninterest Income		
Service charges on deposit accounts	$ 502	$ 501
ATM and check card fees	372	371
Trust and investment advisory fees	346	342
Fees for other customer services	98	73
Gains on sale of loans	43	47
Gains on sale of securities available for sale, net	1,117	
Other operating income	36	6
Total noninterest income	$ 2,514	$ 1,340
Noninterest Expense		

Salaries and employee benefits	$ 2,369	$ 2,288
Occupancy	326	341
Equipment	306	325
Marketing	78	105
Stationery and supplies	81	79
Legal and professional fees	250	201
ATM and check card fees	156	171
FDIC assessment	178	190
Bank franchise tax	76	105
Provision for other real estate owned	401	130
Other real estate owned expense	253	126
Net gains on sale of other real estate owned	(90)	
Telecommunications expense	61	90
Data processing	90	63
Other operating expense	369	341
Total noninterest expense	$ 4,904	$ 4,555

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FIRST NATIONAL CORPORATION

Consolidated Statements of Income

(Continued)

Three months ended March 31, 2012 and 2011

(in thousands, except per share data)

	(unaudited) March 31, 2012	(unaudited) March 31, 2011
Income before income taxes	$ 690	$ 1,450
Income tax provision	215	447
Net income	$ 475	$ 1,003
Effective dividend on preferred stock	224	223
Net income available to common shareholders	$ 251	$ 780
Earnings per common share, basic and diluted	$ 0.08	$ 0.26

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income (Loss)

Three months ended March 31, 2012 and 2011

(in thousands, except per share data)

	(unaudited) March 31, 2012	(unaudited) March 31, 2011
Net income	$ 475	$ 1,003
Other comprehensive income (loss):		
Unrealized gain (loss) on available for sale securities	(150)	308
Reclassification adjustment, net	(1,117)	
Net unrealized gain (loss) on available for sale securities	(1,267)	308
Tax effect	29	181
Total other comprehensive income (loss)	(1,238)	127
Comprehensive income (loss)	$ (763)	$ 1,130

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Three months ended March 31, 2012 and 2011

(in thousands)

	(unaudited) March 31, 2012	(unaudited) March 31, 2011
Cash Flows from Operating Activities		
Net income	$ 475	$ 1,003
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	283	298
Origination of loans held for sale	(1,692)	(3,170)
Proceeds from sale of loans held for sale	1,679	3,338
Gains on sale of loans held for sale	(43)	(47)
Provision for loan losses	2,000	270
Provision for other real estate owned	401	130
Gains on sale of securities available for sale, net	(1,117)	
Net gains on sale of other real estate owned	(90)	
Accretion of discounts and amortization of premiums on securities, net	171	104
Changes in assets and liabilities:		
Decrease in interest receivable	97	35
Increase in other assets	(463)	(439)
(Decrease) increase in other liabilities	(256)	542
Net cash provided by operating activities	$ 1,445	$ 2,064
Cash Flows from Investing Activities		
Proceeds from sales of securities available for sale	$ 24,217	$
Proceeds from maturities, calls, and principal payments of securities available for sale	7,726	2,733
Purchase of securities available for sale	(25,226)	(8,885)
Increase in federal funds sold		(7,500)
Purchase of premises and equipment	(131)	(16)
Proceeds from sale of other real estate owned	2,423	182
Net (increase) decrease in loans	(1,176)	3,897
Net cash provided by (used in) investing activities	$ 7,833	$ (9,589)
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$ 9,817	$ 9,653
Net increase (decrease) in time deposits	(14,394)	4,570
Proceeds from other borrowings		10,000
Principal payments on other borrowings	(5,006)	(10,005)
Cash dividends paid on common stock		(259)
Cash dividends paid on preferred stock	(189)	(190)

Net cash provided by (used in) financing activities	$ (9,772)	$ 13,769
Increase (decrease) in cash and cash equivalents	$ (494)	$ 6,244
Cash and Cash Equivalents		
Beginning	$ 29,524	$ 15,997
Ending	$ 29,030	$ 22,241

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Three months ended March 31, 2012 and 2011

(in thousands)

	(unaudited) March 31, 2012	(unaudited) March 31, 2011
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 1,154	$ 1,514
Income taxes	$	$
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gain (loss) on securities available for sale	$ (1,267)	$ 308
Transfer from loans to other real estate owned	$ 1,922	$ 2,292
Loan originated from sale of other real estate owned	$	$ 640
Issuance of common stock, dividend reinvestment plan	$	$ 36

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

Three months ended March 31, 2012 and 2011

(in thousands, except share and per share data)

(unaudited)

	0000000	0000000	0000000	0000000	0000000	0000000
	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2010	$ 14,127	$ 3,686	$ 1,582	$ 28,969	$ 134	$ 48,498
Net income				1,003		1,003
Other comprehensive income					127	127
Cash dividends on common stock ($0.10 per share)				(295)		(295)
Issuance of 3,402 shares common stock, dividend reinvestment plan		4	32			36
Cash dividends on preferred stock				(190)		(190)
Accretion on preferred stock discount	33			(33)		
Balance, March 31, 2011	$ 14,160	$ 3,690	$ 1,614	$ 29,454	$ 261	$ 49,179

	0000000	0000000	0000000	0000000	0000000	0000000
	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2011	$ 14,263	$ 3,695	$ 1,644	$ 16,503	$ 991	$ 37,096
Net income				475		475
Other comprehensive loss					(1,238)	(1,238)
Cash dividends on preferred stock				(189)		(189)
Accretion on preferred stock discount	36			(36)		
Balance, March 31, 2012	$ 14,299	$ 3,695	$ 1,644	$ 16,753	$ (247)	$ 36,144

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Notes to Consolidated Financial Statements

(unaudited)

Note 1. General

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at March 31, 2012 and December 31, 2011, the results of operations, cash flows and changes in shareholders equity for the three months ended March 31, 2012 and 2011. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2011. Operating results for the three month period ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

Recent Accounting Pronouncements

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

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

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

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FIRST NATIONAL CORPORATION

Notes to Consolidated Financial Statements

(unaudited)

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

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

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at March 31, 2012 and December 31, 2011 were as follows:

	000000000	000000000	000000000	000000000
	(in thousands) March 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 72,893	$ 1,328	$ (102)	$ 74,119
Obligations of states and political subdivisions	9,780	620	(12)	10,388
Corporate equity securities	26	94		120
	$ 82,699	$ 2,042	$ (114)	$ 84,627

000000000	000000000	000000000	000000000

	(in thousands) December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 76,549	$ 2,343	$ (16)	$ 78,876
Obligations of states and political subdivisions	11,895	781		12,676
Corporate equity securities	26	87		113
	$ 88,470	$ 3,211	$ (16)	$ 91,665

Notes to Consolidated Financial Statements

(unaudited)

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

(in thousands)

	March 31, 2012					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	$ 10,802	$ (102)	$	$	$ 10,802	$ (102)
Obligations of states and political subdivisions	550	(12)			550	(12)
	$ 11,352	$ (114)	$	$	$ 11,352	$ (114)

(in thousands)

	December 31, 2011					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	$ 3,955	$ (16)	$	$	$ 3,955	$ (16)

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

At March 31, 2012, there were six U.S. agency and mortgage-backed securities and one obligation of state and political subdivisions in an unrealized loss position. One hundred percent of the Company s investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.7 years at March 31, 2012.

The Company s investment in Federal Home Loan Bank (FHLB) stock totaled $1.9 million at March 31, 2012. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at March 31, 2012, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.

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Notes to Consolidated Financial Statements

(unaudited)

Note 3. Loans

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

	(in thousands) March 31, 2012	December 31, 2011
Real estate loans:		
Construction and land development	$ 49,893	$ 48,363
Secured by 1-4 family residential	125,628	122,339
Other real estate loans	175,738	181,141
Commercial and industrial loans	29,449	29,446
Consumer and other loans	9,686	11,151
Total loans	$ 390,394	$ 392,440
Allowance for loan losses	13,636	12,937
Loans, net	$ 376,758	$ 379,503

Consumer loans included $100 thousand and $325 thousand of demand deposit overdrafts at March 31, 2012 and December 31, 2011, respectively.

The Company considers the following risk characteristics of each loan portfolio class:

Residential mortgage loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

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

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

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

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Notes to Consolidated Financial Statements

(unaudited)

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

	March 31, 2012 (in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction and land development	$ 1,610	$ 206	$ 26	$ 1,842	$ 48,051	$ 49,893	$ 661	$
1-4 family residential	1,216	599	605	2,420	123,537	125,628	2,007	238
Other real estate loans	2,928	1,187	3,181	7,296	168,442	175,738	7,540	131
Commercial and industrial	194	251	158	603	28,846	29,449	162	
Consumer and other loans	64			64	9,622	9,686		
Total	$ 6,012	$ 2,243	$ 3,970	$ 12,225	$ 378,498	$ 390,394	$ 10,370	$ 369

	December 31, 2011 (in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction and land development	$ 2,267	$ 1,029	$ 235	$ 3,531	$ 44,832	$ 48,363	$ 235	$
1-4 family residential	4,179	471	688	5,338	117,001	122,339	3,043	98
Other real estate loans	3,863	562	722	5,147	175,994	181,141	8,367	361
Commercial and industrial	950	93	5	1,048	28,398	29,446	163	
Consumer and other loans	94	19	14	127	11,024	11,151	33	
Total	$ 11,353	$ 2,174	$ 1,664	$ 15,191	$ 377,249	$ 392,440	$ 11,841	$ 459

Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company s loan portfolio, management tracks certain credit quality indicators including trends related to the risk grading of specified classes of loans.

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

Special Mention Loans classified as special mention have a potential weakness that 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.

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Notes to Consolidated Financial Statements

(unaudited)

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 in full of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

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

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

	March 31, 2012 *(in thousands)*				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 26,414	$ 5,490	$ 17,989	$	$ 49,893
Secured by 1-4 family residential	111,006	4,057	10,377	188	125,628
Other real estate loans	133,705	16,956	25,077		175,738
Commercial and industrial	23,403	1,039	4,937	70	29,449
Consumer and other loans	9,606	80			9,686
Total	$ 304,134	$ 27,622	$ 58,380	$ 258	$ 390,394

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

Note 4. Allowance for Loan Losses

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

	(in thousands)		
	March 31, 2012	December 31, 2011	March 31, 2011
Balance at beginning of year	$ 12,937	$ 16,036	$ 16,036
Provision charged to operating expense	2,000	12,380	270
Loan recoveries	125	310	87
Loan charge-offs	(1,426)	(15,789)	(3,225)
Balance at end of period	$ 13,636	$ 12,937	$ 13,168

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Notes to Consolidated Financial Statements

(unaudited)

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

	March 31, 2012 *(in thousands)*					
	Commercial and Industrial	Other Real Estate	Construction and Land Development	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2011	$ 963	$ 5,192	$ 2,843	$ 3,766	$ 173	$ 12,937
Charge-offs		(503)	(369)	(481)	(73)	(1,426)
Recoveries	5	52		2	66	125
Provision for loan losses	(170)	649	679	854	(12)	2,000
Ending Balance, March 31, 2012	$ 798	$ 5,390	$ 3,153	$ 4,141	$ 154	$ 13,636
Ending Balance:						
Individually evaluated for impairment	134	574	1,062	1,041		2,811
Collectively evaluated for impairment	664	4,816	2,091	3,100	154	10,825
Loans:						
Ending Balance	29,449	175,738	49,893	125,628	9,686	390,394
Individually evaluated for impairment	481	9,453	5,742	5,946		21,622
Collectively evaluated for impairment	28,968	166,285	44,151	119,682	9,686	368,772

	December 31, 2011 *(in thousands)*					
	Commercial and Industrial	Other Real Estate	Construction and Land Development	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2010	$ 858	$ 9,187	$ 4,050	$ 1,681	$ 260	$ 16,036
Charge-offs	(348)	(7,551)	(2,983)	(4,639)	(268)	(15,789)
Recoveries	3		50	6	251	310
Provision for loan losses	450	3,556	1,726	6,718	(70)	12,380
Ending Balance, December 31, 2011	$ 963	$ 5,192	$ 2,843	$ 3,766	$ 173	$ 12,937
Ending Balance:						
Individually evaluated for impairment	309	351	930	848		2,438

Collectively evaluated for impairment	654	4,841	1,913	2,918	173	10,499
Loans:						
Ending Balance	29,446	181,141	48,363	122,339	11,151	392,440
Individually evaluated for impairment	480	10,940	7,640	6,860		25,920
Collectively evaluated for impairment	28,966	170,201	40,723	115,479	11,151	366,520

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(unaudited)

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

	0000000	0000000	0000000	0000000	0000000	0000000	0000000
				March 31, 2012 *(in thousands)*			
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	$ 6,118	$ 634	$ 5,108	$ 5,742	$ 1,062	$ 5,571	$ 82
Secured by 1-4 family	7,060	1,507	4,439	5,946	1,041	4,488	55
Other real estate loans	13,963	7,480	1,973	9,453	574	10,879	30
Commercial and industrial	481		481	481	134	480	5
Consumer and other loans							
Total	$ 27,622	$ 9,621	$ 12,001	$ 21,622	$ 2,811	$ 21,418	$ 172

	0000000	0000000	0000000	0000000	0000000	0000000	0000000
				December 31, 2011 *(in thousands)*			
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction and land development	$ 8,106	$ 3,531	$ 4,109	$ 7,640	$ 930	$ 7,077	$ 367
Secured by 1-4 family	8,566	3,495	3,365	6,860	848	6,519	301
Other real estate loans	15,165	8,135	2,805	10,940	351	23,918	396
Commercial and industrial	480		480	480	309	660	27
Consumer and other loans							
Total	$ 32,317	$ 15,161	$ 10,758	$ 25,920	$ 2,438	$ 38,174	$ 1,091

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

As of March 31, 2012, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled $5.4 million. At March 31, 2012, $1.4 million of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were $11.4 million in TDRs at December 31, 2011. There were no new loans modified under TDRs during the three month period ended March 31, 2012. There were no TDRs that defaulted during the three month period ended March 31, 2012.

Notes to Consolidated Financial Statements

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Note 5. Other Real Estate Owned

At March 31, 2012 and December 31, 2011, OREO totaled $5.6 million and $6.4 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties associated with commercial relationships, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows:

	0000000000	0000000000
	(in thousands)	
	For the three months ended March 31, 2012	For the year ended December 31, 2011
Balance at the beginning of year, gross	$ 9,166	$ 7,302
Transfers from loans	1,922	8,117
Charge-offs	(738)	(2,022)
Sales proceeds	(2,423)	(3,321)
Gain (loss) on disposition	90	(910)
Balance at the end of period, gross	8,017	9,166