FIRST NATIONAL CORP /VA/
Form 10-Q
August 10, 2018

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018
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)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant 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 No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of August 10, 2018, 4,956,206 shares of common stock, par value $1.25 per share, of the registrant were outstanding.

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FIRST NATIONAL CORPORATION
Consolidated Balance Sheets
(in thousands, except share and per share data)

	(unaudited) June 30, 2018	December 31, 2017*
Assets		
Cash and due from banks	$ 13,501	$ 11,358
Interest-bearing deposits in banks	27,762	28,628
Securities available for sale, at fair value	106,707	89,255
Securities held to maturity, at amortized cost (fair value, 2018, $44,416; 2017, $47,702)	45,701	48,208
Restricted securities, at cost	1,590	1,570
Loans held for sale	1,195	438
Loans, net of allowance for loan losses, 2018, $5,039; 2017, $5,326	525,894	516,875
Other real estate owned, net of valuation allowance, 2018, $0; 2017, $0	68	326
Premises and equipment, net	19,633	19,891
Accrued interest receivable	2,073	1,916
Bank owned life insurance	13,787	13,967
Core deposit intangibles, net	679	930
Other assets	4,774	5,748
Total assets	$ 763,364	$ 739,110
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 196,839	$ 180,912
Savings and interest-bearing demand deposits	367,399	361,417
Time deposits	122,291	122,651
Total deposits	$ 686,529	$ 664,980
Subordinated debt	4,956	4,948
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	952	1,749
Total liabilities	$ 701,716	$ 680,956
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, 2018, 4,953,356 shares; 2017, 4,945,702 shares	6,192	6,182
Surplus	7,346	7,260
Retained earnings	50,313	45,670
Accumulated other comprehensive loss, net	(2,203)	(958)
Total shareholders' equity	$ 61,648	$ 58,154
Total liabilities and shareholders' equity	$ 763,364	$ 739,110

*Derived from audited consolidated financial statements.
See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION
Consolidated Statements of Income (Unaudited)
(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Interest and Dividend Income				
Interest and fees on loans	$6,546	$ 5,933	$12,851	$11,579
Interest on deposits in banks	186	86	346	147
Interest and dividends on securities:				
Taxable interest	776	634	1,456	1,296
Tax-exempt interest	156	145	301	288
Dividends	22	21	44	41
Total interest and dividend income	$7,686	$ 6,819	$14,998	$13,351
Interest Expense				
Interest on deposits	$665	$ 405	$1,255	$788
Interest on subordinated debt	89	89	178	178
Interest on junior subordinated debt	101	76	187	144
Total interest expense	$855	$ 570	$1,620	$1,110
Net interest income	$6,831	$ 6,249	$13,378	$12,241
Provision for loan losses	—	—	100	—
Net interest income after provision for loan losses	$6,831	$ 6,249	$13,278	$12,241
Noninterest Income				
Service charges on deposit accounts	$784	$ 735	$1,546	$1,490
ATM and check card fees	555	527	1,074	1,028
Wealth management fees	409	355	816	702
Fees for other customer services	151	137	304	277
Income from bank owned life insurance	77	102	636	195
Net gains on securities available for sale	—	13	—	13
Net gains on sale of loans	15	34	24	67
Other operating income	76	75	300	147
Total noninterest income	$2,067	$ 1,978	$4,700	$3,919
Noninterest Expense				
Salaries and employee benefits	$3,227	$ 3,122	$6,610	$6,364
Occupancy	387	348	787	715
Equipment	420	400	843	808
Marketing	161	136	270	272
Supplies	88	105	168	196
Legal and professional fees	223	245	414	442
ATM and check card expense	211	229	414	391
FDIC assessment	66	77	148	156
Bank franchise tax	118	110	233	214
Telecommunications expense	98	108	134	218
Data processing expense	170	152	332	302
Postage expense	42	74	103	135
Amortization expense	120	160	251	329
Other real estate owned expense (income), net	1	4	(22)	6

Other operating expense	532	435	1,045	908
Total noninterest expense	$5,864	$5,705	$11,730	$11,456

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Income (Unaudited)
(Continued)
(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Income before income taxes	$3,034	$ 2,522	$6,248	$ 4,704
Income tax expense	583	766	1,110	1,405
Net income	$2,451	$ 1,756	$5,138	$ 3,299
Earnings per common share				
Basic	$0.49	$ 0.36	$1.04	$ 0.67
Diluted	$0.49	$ 0.36	$1.04	$ 0.67

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Comprehensive Income (Unaudited)
(in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Net income	$2,451	$1,756	$5,138	$3,299
Other comprehensive (loss) income, net of tax,				
Unrealized holding (losses) gains on available for sale securities, net of tax ($75) and $201 for the three months and ($304) and $397 for the six months ended June 30, 2018 and 2017, respectively	(284)	392	(1,146)	773
Reclassification adjustment for gains included in net income, net of tax $0 and ($4) for the three months and $0 and ($4) for the six months ended June 30, 2018 and 2017, respectively	—	(9)	—	(9)
Pension liability adjustment, net of tax $0 and $0 for the three months and ($27) and $0 for the six months ended June 30, 2018 and 2017, respectively	—	—	(99)	—
Total other comprehensive (loss) income	(284)	383	(1,245)	764
Total comprehensive income	$2,167	$2,139	$3,893	$4,063

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Six Months Ended June 30, 2018	June 30, 2017
Cash Flows from Operating Activities		
Net income	$ 5,138	$ 3,299
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	681	697
Amortization of core deposit intangibles	251	329
Amortization of debt issuance costs	8	9
Origination of loans held for sale	(2,057)	(4,582)
Proceeds from sale of loans held for sale	1,324	3,987
Net gains on sales of loans held for sale	(24)	(67)
Provision for loan losses	100	—
Net gains on securities available for sale	—	(13)
Net gains on sale of other real estate owned	(24)	—
Increase in cash value of bank owned life insurance	(167)	(187)
Accretion of discounts and amortization of premiums on securities, net	274	313
Accretion of premium on time deposits	(43)	(56)
Stock-based compensation	89	76
Excess tax benefits on stock-based compensation	(7)	(14)
	51	(157)

Deferred income tax expense (benefit)						
Changes in assets and liabilities:						
(Increase) decrease in interest receivable	(157		)	18		
Decrease in other assets	1,234			1		
Decrease in accrued expenses and other liabilities	(896		)	(412		)
Net cash provided by operating activities	$	5,775		$	3,241	
Cash Flows from Investing Activities						
Proceeds from maturities, calls, and principal payments of securities available for sale	$	8,064		$	7,103	
Proceeds from maturities, calls, and principal payments of securities held to maturity	2,413			2,468		
Purchases of securities available for sale	(27,146		)	(1,079		)
Net purchase of restricted securities	(20		)	(22		)
Purchase of premises and equipment	(423		)	(413		)
Proceeds from sale of other real estate owned	350			—		
Proceeds from cash value of bank owned life insurance	347			—		
Net increase in loans	(9,187		)	(17,643		)
Net cash used in investing activities	$	(25,602	)	$	(9,586	)

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows (Unaudited)
(Continued)
(in thousands)

	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$21,909	$21,765
Net decrease in time deposits	(317)	(5,451)
Cash dividends paid on common stock, net of reinvestment	(464)	(323)
Repurchase of common stock	(24)	—
Net cash provided by financing activities	$21,104	$15,991
Increase in cash and cash equivalents	$1,277	$9,646
Cash and Cash Equivalents		
Beginning	$39,986	$41,092
Ending	$41,263	$50,738
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$1,656	$1,174
Income Taxes	$96	$1,736
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized (losses) gains on securities available for sale	$(1,450)	$1,157
Change in pension liability	$(126)	$—
Transfer from loans to other real estate owned	$68	$—
Issuance of common stock, dividend reinvestment plan	$31	$23

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
(in thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2016	$ —	$ 6,162	$ 7,093	$ 39,756	$ (860)	$ 52,151
Net income	—	—	—	3,299	—	3,299
Other comprehensive income	—	—	—	—	764	764
Cash dividends on common stock ($0.07 per share)	—	—	—	(346)	—	(346)
Stock-based compensation	—	—	76	—	—	76
Issuance of 1,665 shares common stock, dividend reinvestment plan	—	2	21	—	—	23
Issuance of 10,536 shares common stock, stock incentive plan	—	13	(13)	—	—	—
Balance, June 30, 2017	$ —	$ 6,177	$ 7,177	$ 42,709	$ (96)	$ 55,967

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2017	$ —	$ 6,182	$ 7,260	$ 45,670	$ (958)	$ 58,154
Net income	—	—	—	5,138	—	5,138
Other comprehensive loss	—	—	—	—	(1,245)	(1,245)
Cash dividends on common stock ($0.10 per share)	—	—	—	(495)	—	(495)
Stock-based compensation	—	—	89	—	—	89
Issuance of 1,632 shares common stock, dividend reinvestment plan	—	2	29	—	—	31
Issuance of 7,339 shares common stock, stock incentive plan	—	9	(9)	—	—	—
Repurchase of 1,317 shares of common stock, stock incentive plan	—	(1)	(23)	—	—	(24)
Balance, June 30, 2018	$ —	$ 6,192	$ 7,346	$ 50,313	$ (2,203)	$ 61,648

See Notes to Consolidated Financial Statements

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 subsidiary, First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2018 and December 31, 2017, the statements of income and comprehensive income for the three and six months ended June 30, 2018 and 2017 and the cash flows and changes in shareholders' equity for the six months ended June 30, 2018 and 2017. 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, 2017. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

Adoption of ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606."

On January 1, 2018, the Company adopted ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606." This ASU revised guidance for the recognition, measurement, and disclosure of revenue from contracts with customers. The original guidance was amended through subsequent accounting standard updates that resulted in technical corrections, improvements, and a one-year deferral of the effective date to January 1, 2018. The guidance, as amended, is applicable to all entities and replaces significant portions of existing industry and transaction-specific revenue recognition rules with a more principles-based recognition model. Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of the guidance. Gains and losses on investment securities, derivatives, financial guarantees, and sales of financial instruments are similarly excluded from the scope. The guidance is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees, and merchant income. The Company adopted this guidance via the modified retrospective approach, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, and merchant income. The Company also completed an evaluation of certain costs related to these revenue streams to determine whether such costs should be presented gross versus net. Based on these assessments, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 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

Notes to Consolidated Financial Statements (Unaudited)

financial statements. The Company has analyzed its current lease commitments, along with reasonable assumptions to project lease activity in future periods, to measure the potential impact on net income and relevant capital and financial ratios.

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. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. The Company has formed a committee to address the compliance requirements of this ASU and is currently in the process of analyzing gathered data, defining loan pools and segments, and selecting methods for applying the concepts included in this ASU. During 2018, the Company plans to test selected models, build policy and process documentation, and model the impact of the ASU on the capital and strategic plans. This guidance may result in material changes in the Company's accounting for credit losses of financial instruments.

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. 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.

In March 2017, the FASB issued ASU No. 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company does not expect the adoption of ASU 2017-08 to have a material impact on its consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The Company is currently assessing the impact that ASU 2017-12 will have on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-03, "Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments provide targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, the amendments include clarifications related to: measurement elections, transition requirements, and adjustments associated with equity securities without readily determinable fair values; fair value measurement requirements for forward contracts and purchased options on equity securities; presentation requirements for hybrid financial liabilities for which the fair value option has been elected; and measurement requirements for liabilities denominated in a foreign currency for which the fair value option has been elected. The amendments are effective for fiscal years beginning after December 15, 2017,

Notes to Consolidated Financial Statements (Unaudited)

and interim periods within those fiscal years beginning after June 15, 2018. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-03 to have a material impact on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, "Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 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 state and political subdivisions, and corporate debt securities. Amortized costs and fair values of securities at June 30, 2018 and December 31, 2017 were as follows (in thousands):

	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	$94,387	$ 21	$ (2,580)	$91,828
Obligations of states and political subdivisions	15,109	46	(276)	14,879
Total securities available for sale	$109,496	$ 67	$ (2,856)	$106,707
Securities held to maturity:				
U.S. agency and mortgage-backed securities	$29,678	$ —	$ (1,111)	$28,567
Obligations of states and political subdivisions	14,523	17	(189)	14,351
Corporate debt securities	1,500	—	(2)	1,498
Total securities held to maturity	$45,701	$ 17	$ (1,302)	$44,416
Total securities	$155,197	$ 84	$ (4,158)	$151,123

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	$76,074	$ 67	$ (1,337)	$74,804
Obligations of states and political subdivisions	14,520	86	(155)	14,451
Total securities available for sale	$90,594	$ 153	$ (1,492)	$89,255
Securities held to maturity:				
U.S. agency and mortgage-backed securities	$32,149	$ —	$ (551)	$31,598
Obligations of states and political subdivisions	14,559	74	(45)	14,588
Corporate debt securities	1,500	16	—	1,516
Total securities held to maturity	$48,208	$ 90	$ (596)	$47,702
Total securities	$138,802	$ 243	$ (2,088)	$136,957

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Notes to Consolidated Financial Statements (Unaudited)

At June 30, 2018 and December 31, 2017, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	June 30, 2018					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities available for sale:						
U.S. agency and mortgage-backed securities	$61,734	$ (1,200)	$28,279	$ (1,380)	$90,013	$ (2,580)
Obligations of states and political subdivisions	8,055	(129)	2,462	(147)	10,517	(276)
Total securities available for sale	$69,789	$ (1,329)	$30,741	$ (1,527)	$100,530	$ (2,856)
Securities held to maturity:						
U.S. agency and mortgage-backed securities	$14,964	$ (499)	$13,603	$ (612)	$28,567	$ (1,111)
Obligations of states and political subdivisions	11,155	(189)	—	—	11,155	(189)
Corporate debt securities	1,498	(2)	—	—	1,498	(2)
Total securities held to maturity	$27,617	$ (690)	$13,603	$ (612)	$41,220	$ (1,302)
Total securities	$97,406	$ (2,019)	$44,344	$ (2,139)	$141,750	$ (4,158)

	December 31, 2017					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities available for sale:						
U.S. agency and mortgage-backed securities	$29,963	$ (286)	$30,362	$ (1,051)	$60,325	$ (1,337)
Obligations of states and political subdivisions	4,469	(53)	1,961	(102)	6,430	(155)
Total securities available for sale	$34,432	$ (339)	$32,323	$ (1,153)	$66,755	$ (1,492)
Securities held to maturity:						
U.S. agency and mortgage-backed securities	$18,301	$ (205)	$13,297	$ (346)	$31,598	$ (551)
Obligations of states and political subdivisions	6,889	(45)	—	—	6,889	(45)
Total securities held to maturity	$25,190	$ (250)	$13,297	$ (346)	$38,487	$ (596)
Total securities	$59,622	$ (589)	$45,620	$ (1,499)	$105,242	$ (2,088)

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.

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At June 30, 2018, there were eighty-six out of ninety-one U.S. agency and mortgage-backed securities, fifty-eight out of eighty-one 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 4.8 years at June 30, 2018. At December 31, 2017, there were sixty-eight out of eighty-two U.S. agency and mortgage-backed securities and thirty-nine out of eighty 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, 2017. The weighted-average re-pricing term of the portfolio was 4.7 years at December 31, 2017. The unrealized losses at June 30, 2018 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 June 30, 2018 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.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	$505	$511	$186	$186
Due after one year through five years	8,982	8,919	6,918	6,790
Due after five years through ten years	14,164	13,723	14,282	14,034
Due after ten years	85,845	83,554	24,315	23,406
	$109,496	$106,707	$45,701	$44,416

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 June 30, 2018, and no impairment has been recognized.

The composition of restricted securities at June 30, 2018 and December 31, 2017 was as follows (in thousands):

	June 30, 2018	December 31, 2017
Federal Home Loan Bank stock	$ 665	$ 645
Federal Reserve Bank stock	875	875
Community Bankers' Bank stock	50	50
	$ 1,590	$ 1,570

Notes to Consolidated Financial Statements (Unaudited)

Note 3. Loans

Loans at June 30, 2018 and December 31, 2017 are summarized as follows (in thousands):

	June 30, 2018	December 31, 2017
Real estate loans:		
Construction and land development	$37,350	$ 35,927
Secured by 1-4 family residential	211,101	208,177
Other real estate loans	224,362	222,256
Commercial and industrial loans	40,943	38,763
Consumer and other loans	17,177	17,078
Total loans	$530,933	$ 522,201
Allowance for loan losses	(5,039)	(5,326)
Loans, net	$525,894	$ 516,875

Net deferred loan fees included in the above loan categories were $266 thousand and $301 thousand at June 30, 2018 and December 31, 2017, respectively. Consumer and other loans included $231 thousand and $232 thousand of demand deposit overdrafts at June 30, 2018 and December 31, 2017, respectively.
Risk characteristics of each loan portfolio class that are considered by the Company include:

- 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, if any. These loans are typically either unsecured or secured by rapidly depreciating assets such as automobiles. They are also likely to be immediately and adversely affected by job loss, divorce, illness, personal bankruptcy, or other changes in circumstances. Consumer and other loans also include purchased consumer loans which could have been originated outside of the Company's market area.

Notes to Consolidated Financial Statements (Unaudited)

The following tables provide a summary of loan classes and an aging of past due loans as of June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018							
	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	$170	$ —	$ 355	$ 525	$36,825	$37,350	$ —	$ 355
Secured by 1-4 family residential	1,218	292	359	1,869	209,232	211,101	375	76
Other real estate loans	1,426	319	1,587	3,332	221,030	224,362	1,755	—
Commercial and industrial	—	210	75	285	40,658	40,943	200	75
Consumer and other loans	88	53	43	184	16,993	17,177	—	43
Total	$2,902	$ 874	$ 2,419	$ 6,195	$524,738	$530,933	$ 2,330	$ 549

	December 31, 2017							
	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	$986	$ 30	$ 40	$ 1,056	$34,871	$35,927	$ 269	$ 40
Secured by 1-4 family residential	606	203	148	957	207,220	208,177	267	106
Other real estate loans	2,042	170	10	2,222	220,034	222,256	401	10
Commercial and industrial	184	25	—	209	38,554	38,763	—	—
Consumer and other loans	51	49	27	127	16,951	17,078	—	27
Total	$3,869	$ 477	$ 225	$ 4,571	$517,630	$522,201	$ 937	$ 183

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.

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 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.

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$34,862	$751	$1,737	$—	$37,350
Secured by 1-4 family residential	207,451	1,896	1,754	—	211,101
Other real estate loans	220,695	1,314	2,353	—	224,362
Commercial and industrial	40,632	27	284	—	40,943
Consumer and other loans	17,177	—	—	—	17,177
Total	$520,817	$3,988	$6,128	$—	$530,933

	December 31, 2017				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$31,553	$2,268	$2,106	$—	$35,927
Secured by 1-4 family residential	204,166	1,933	2,078	—	208,177
Other real estate loans	215,773	971	5,512	—	222,256
Commercial and industrial	38,606	53	104	—	38,763
Consumer and other loans	17,078	—	—	—	17,078
Total	$507,176	$5,225	$9,800	$—	$522,201

Notes to Consolidated Financial Statements (Unaudited)

Note 4. Allowance for Loan Losses

The following tables present, as of June 30, 2018, December 31, 2017 and June 30, 2017, the total allowance for loan losses, the allowance by impairment methodology, and loans by impairment methodology (in thousands):

	June 30, 2018					
	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, 2017	$414	$775	$2,948	$ 418	$771	$5,326
Charge-offs	—	(24)	—	(8)	(468)	(500)
Recoveries	—	8	1	5	99	113
Provision for (recovery of) loan losses	(8)	32	(285)	10	351	100
Ending Balance, June 30, 2018	$406	$791	$2,664	$ 425	$753	$5,039
Ending Balance:						
Individually evaluated for impairment	—	—	—	—	—	—
Collectively evaluated for impairment	406	791	2,664	425	753	5,039
Loans:						
Ending Balance	$37,350	$211,101	$224,362	$ 40,943	$17,177	$530,933
Individually evaluated for impairment	865	1,330	2,029	257	—	4,481
Collectively evaluated for impairment	36,485	209,771	222,333	40,686	17,177	526,452

	December 31, 2017					
	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, 2016	$441	$1,019	$3,142	$ 380	$339	$5,321
Charge-offs	—	(126)	—	—	(607)	(733)
Recoveries	11	302	50	10	265	638
Provision for (recovery of) loan losses	(38)	(420)	(244)	28	774	100
Ending Balance, December 31, 2017	$414	$775	$2,948	$ 418	$771	$5,326
Ending Balance:						
Individually evaluated for impairment	—	—	—	—	—	—
Collectively evaluated for impairment	414	775	2,948	418	771	5,326
Loans:						
Ending Balance	$35,927	$208,177	$222,256	$ 38,763	$17,078	$522,201
Individually evaluated for impairment	1,150	1,307	1,289	65	—	3,811
Collectively evaluated for impairment	34,777	206,870	220,967	38,698	17,078	518,390

Notes to Consolidated Financial Statements (Unaudited)

	June 30, 2017					
	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, 2016	$441	$1,019	$3,142	$ 380	$339	$5,321
Charge-offs	—	(25)	—	—	(242)	(267)
Recoveries	2	238	47	7	96	390
Provision for (recovery of) loan losses	39	(360)	(115)	(12)	448	—
Ending Balance, June 30, 2017	$482	$872	$3,074	$ 375	$641	$5,444
Ending Balance:						
Individually evaluated for impairment	—	57	—	—	—	57
Collectively evaluated for impairment	482	815	3,074	375	641	5,387
Loans:						
Ending Balance	$36,783	$205,114	$215,742	$ 31,201	$14,993	$503,833
Individually evaluated for impairment	1,613	1,772	1,355	67	—	4,807
Collectively evaluated for impairment	35,170	203,342	214,387	31,134	14,993	499,026

Notes to Consolidated Financial Statements (Unaudited)

Impaired loans and the related allowance at June 30, 2018, December 31, 2017 and June 30, 2017, were as follows (in thousands):