

**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, 2020

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 1-38874



(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

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

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

22657
(Zip Code)

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

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

<u>Title of each class</u>	<u>Trading symbol(s)</u>	<u>Name of each exchange on which registered</u>
Common stock, par value \$1.25 per share	FXNC	The Nasdaq Stock Market LLC

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

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 every Interactive Data File required to be submitted 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 such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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 ☒

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 has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C. 7262(b)) by the registered public accounting firm that prepared or issued its audit report. ☐

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, 2020 was \$59,149,339.

The number of outstanding shares of common stock as of March 30, 2021 was 4,868,462.

DOCUMENTS INCORPORATED BY REFERENCE
Proxy Statement for the 2021 Annual Meeting of Shareholders – Part III

TABLE OF CONTENTS

	<u>Page</u>
<u>Part I</u>	
Item 1. Business	4
Item 1A. Risk Factors	12
Item 1B. Unresolved Staff Comments	23
Item 2. Properties	23
Item 3. Legal Proceedings	23
Item 4. Mine Safety Disclosures	23
<u>Part II</u>	
Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	24
Item 6. Selected Financial Data	25
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations	26
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	46
Item 8. Financial Statements and Supplementary Data	46
Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	94
Item 9A. Controls and Procedures	94
Item 9B. Other Information	94
<u>Part III</u>	
Item 10. Directors, Executive Officers and Corporate Governance	95
Item 11. Executive Compensation	95
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	95
Item 13. Certain Relationships and Related Transactions, and Director Independence	95
Item 14. Principal Accounting Fees and Services	95
<u>Part IV</u>	
Item 15. Exhibits, Financial Statement Schedules	96

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, but are not limited to, statements regarding profitability, liquidity, adequacy of capital, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and the impact of the Company's acquisition (the Merger) of The Bank of Fincastle (Fincastle), including the expected levels of merger related expenses to be incurred by the Company and the potential impact of the Merger on the Company's and First Bank's (the Bank) liquidity and capital levels, as well as certain 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:

- the ability of the Company and the Bank to realize the anticipated benefits of the Merger, including the ability to close the Merger within the expected time frame, or at all, and to successfully integrate Fincastle's systems and processes into the Company's systems and processes;
- expected revenue synergies and cost savings from the Merger that may not be fully realized or realized within the expected time frame;
- revenues following the Merger that may be lower than expected;
- customer and employee relationships and business operations as a result of disruptions caused by the Merger;
- the effects of the COVID-19 pandemic, including its potential adverse effect on economic conditions and the Company's employees, customers, credit quality, and financial performance;
- general business conditions, as well as conditions within the financial markets;
- general economic conditions, including unemployment levels and slowdowns in economic growth;
- the Company's branch and market expansions, technology initiatives and other strategic initiatives;
- the impact of competition from banks and non-banks, including financial technology companies (Fintech);
- the composition of the loan and deposit portfolio, including the types of accounts and customers, may change, which could impact the amount of net interest income and noninterest income in future periods, including revenue from service charges on deposits;
- limited availability of financing or inability to raise capital;
- reliance on third parties for key services;
- the Company's credit standards and its on-going credit assessment processes might not protect it from significant credit losses;
- the quality of the loan portfolio and the value of the collateral securing those loans;
- demand for loan products;
- deposit flows;
- the level of net charge-offs on loans and the adequacy of the allowance for loan losses;
- the concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets;
- the value of securities held in the Company's investment portfolio;
- legislative or regulatory changes or actions, including the effects of changes in tax laws;
- accounting principles, policies and guidelines and elections made by the Company thereunder;
- cyber threats, attacks or events;
- the ability to maintain adequate liquidity by retaining deposit customers and secondary funding sources, especially if the Company's reputation would become damaged;

- monetary and fiscal policies of the U.S. Government, including policies of the U.S. Department of the Treasury and the Federal Reserve Board, and the effect of those policies on interest rates and business in the Company's markets;
- changes in interest rates could have a negative impact on the Company's net interest income and an unfavorable impact on the Company'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.

[Table of Contents](#)

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 and, together with Trust II, the Trusts)

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 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.

On February 18, 2021, the Company, the Bank and Fincastle entered into an agreement and plan of merger, pursuant to which Fincastle will merge with and into First Bank, with First Bank being the surviving entity in the Merger. Upon completion of the Merger, each outstanding share of Fincastle common stock will be converted into the right to receive, without interest, one of the following: (i) \$3.30 in cash, (ii) a number of shares of the Company's common stock equal to the 0.1649 shares of the Company's common stock for each share of Fincastle common stock, or (iii) a combination of cash and the Company's common stock. Fincastle shareholders will have the right to elect the form of consideration paid, subject to the limitations that 80% of Fincastle's outstanding shares of common stock will be exchanged for the Company's common stock and 20% of Fincastle's outstanding shares of common stock will be exchanged for cash consideration. If Fincastle shareholders elect for more than 20% of Fincastle's outstanding shares of common stock to be exchanged for cash consideration, the Company has the unilateral right to increase the amount of cash paid up to 22% of Fincastle's outstanding shares of common stock.

Completion of the Merger is subject to the approval of the respective shareholders of Fincastle and the Company, regulatory approvals, and other customary closing conditions. Pursuant to the Agreement, three directors of Fincastle will be invited to serve on the boards of directors of the Company and the Bank. The transaction is expected to close in the third quarter of 2021.

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. The information on the Company's website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

Products and Services

The Bank offers loan, deposit, and wealth management products and services. Loan products and services include consumer loans, residential mortgages, home equity loans, and commercial loans. Deposit products and services include checking accounts, treasury management solutions, savings accounts, money market accounts, certificates of deposit, and individual retirement accounts. Wealth management services include estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. Customers include small and medium-sized businesses, individuals, estates, local governmental entities, and non-profit organizations. 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, central regions of Virginia, and the city of Richmond. Within this market area, there are diverse types of industry including medical and professional services, manufacturing, retail, warehousing, Federal government, hospitality, and higher education.

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

[Table of Contents](#)

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, marketplace lenders and other financial technology firms, 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 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, 2020, the Bank was ranked third overall in its market area with 10.53% 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, 2020, the Bank employed a total of 150 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 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.

[Table of Contents](#)

The Company

General. As a bank holding company registered under the Bank Holding Company Act of 1956 (the BHCA), the Company is subject to supervision, regulation, and examination by the Board of Governors of the Federal Reserve System (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 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 Wall Street Reform and Consumer Protection Act (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 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.

[Table of Contents](#)

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. Pursuant to the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement, qualifying bank holding companies with total consolidated assets of less than \$3 billion, such as the Company, are not subject to consolidated regulatory capital requirements. Certain capital requirements applicable to the Bank 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. In addition, under the current supervisory practices of the Federal Reserve, the Company should inform and consult with its regulators reasonably in advance of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the Company’s capital structure.

The Company’s subordinated debt is senior in right of payment 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.

The Company’s ability to pay dividends on common stock is also limited by contractual restrictions under its 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.

Effective January 1, 2015, the Bank became subject to capital rules adopted by federal bank regulators implementing the Basel III regulatory capital reforms adopted by the Basel Committee on Banking Supervision (the Basel Committee), and certain changes required by the Dodd-Frank Act.

[Table of Contents](#)

The minimum capital level requirements applicable to the Bank under the rules are as follows: a common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6%; a total capital ratio of 8%; 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 of 2.5% of risk-weighted assets. This resulted in the following minimum capital 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 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 of December 31, 2020 and December 31, 2019, 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, 2020:

	First Bank
Total capital to risk-weighted assets	15.82 %
Tier 1 capital to risk-weighted assets	14.57 %
Common equity Tier 1 capital to risk-weighted assets	14.57 %
Tier 1 capital to average assets	8.80 %
Capital conservation buffer ratio(1)	7.82 %

- (1) Calculated by subtracting the regulatory minimum capital ratio requirements from the Bank’s actual ratio for 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 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 required to meet the following capital level requirements in order to qualify as “well capitalized:” a common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8%; a total capital ratio of 10%; and a Tier 1 leverage ratio of 5%. The Bank met the requirements to qualify as “well capitalized” as of December 31, 2020 and December 31, 2019.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms (the standards are commonly referred to as “Basel IV”). Among other things, these standards revised the Basel Committee’s standardized approach for credit risk (including by recalibrating risk weights and introducing new capital requirements for certain “unconditionally cancellable commitments,” such as unused credit card lines of credit) and provided a new standardized approach for operational risk capital. Under the proposed framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing-in through January 1, 2027. Under the current capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to the Company. The impact of Basel IV on the Company and the Bank will depend on the manner in which it is implemented by the federal bank regulatory agencies.

On September 17, 2019 the FDIC finalized a rule that introduced an optional simplified measure of capital adequacy for qualifying community banking organizations (i.e., the community bank leverage ratio (CBLR) framework), as required by the Economic Growth, Regulatory Relief and Consumer Protection Act (the Economic Growth Act). The CBLR framework is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.

In order to qualify for the CBLR framework, a community banking organization must have a tier 1 leverage ratio greater than 9%, have less than \$10 billion in total consolidated assets, and limited amounts of off-balance sheet exposures and trading assets and liabilities. The Coronavirus Aid, Relief and Economic Security (CARES) Act temporarily lowered the tier 1 leverage ratio requirement to 8% until December 31, 2020. A qualifying community banking organization that opts into the CBLR framework and meets all requirements under the framework will be considered to have met the “well-capitalized” ratio requirements under the prompt corrective action regulations and will not be required to report or calculate risk-based capital. Although the Bank did not opt into the CBLR framework at December 31, 2020, it may opt into the CBLR framework in a future quarterly period. For further discussion regarding the CARES Act, see “CARES Act” below.

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%.

[Table of Contents](#)

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 3 to 30 basis points for established small banks, subject to a decrease for issuance of long-term unsecured debt, including senior unsecured debt and subordinated debt and an increase for holdings of long-term unsecured or subordinated debt issued by other insured banks. 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. The reserve ratio reached 1.35% during the third quarter of 2018.

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 were required until the Financing Corporation bonds matured in 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 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, 2020.

Community Reinvestment Act. The Bank is subject to the requirements of the CRA. 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. In 2018, the most recent notification from the Federal Reserve, the Bank received a "satisfactory" CRA rating.

Privacy Legislation. Several 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.

[Table of Contents](#)

Anti-Money Laundering Laws and Regulations. The Bank is subject to several federal laws that are designed to combat money laundering, terrorist financing, and transactions with persons, companies or foreign governments designated by U.S. authorities (“AML laws”). This category of laws includes the Bank Secrecy Act of 1970, the Money Laundering Control Act of 1986, the USA PATRIOT Act of 2001, and the Anti-Money Laundering Act of 2020. The Anti-Money Laundering Act of 2020, the most sweeping anti-money laundering legislation in 20 years, requires various federal agencies to promulgate regulations implementing a number of its provisions.

The AML laws and their implementing regulations require insured depository institutions, broker-dealers, and certain other financial institutions to have policies, procedures, and controls to detect, prevent, and report money laundering and terrorist financing. The AML laws and their regulations also provide for information sharing, subject to conditions, between federal law enforcement agencies and financial institutions, as well as among financial institutions, for counter-terrorism purposes. Federal banking regulators are required, when reviewing bank holding company acquisition and bank merger applications, to take into account the effectiveness of the anti-money laundering activities of the applicants. To comply with these obligations, the Company has implemented appropriate internal practices, procedures, and controls.

Cybersecurity. The federal banking agencies have adopted guidelines for establishing information security standards and cybersecurity programs for implementing safeguards under the supervision of a financial institution’s board of directors. These guidelines, along with related regulatory materials, increasingly focus on risk management and processes related to information technology and the use of third parties in the provision of financial products and services. The federal banking agencies expect financial institutions to establish lines of defense and ensure that their risk management processes also address the risk posed by compromised customer credentials, and also expect financial institutions to maintain sufficient business continuity planning processes to ensure rapid recovery, resumption and maintenance of the institution’s operations after a cyber-attack. If the Bank fails to meet the expectations set forth in this regulatory guidance, it could be subject to various regulatory actions and any remediation efforts may require significant resources of the Bank. In addition, all federal and state bank regulatory agencies continue to increase focus on cybersecurity programs and risks as part of regular supervisory exams.

In December 2020, the federal banking agencies issued a notice of proposed rulemaking that would require banking organizations to notify their primary regulator within 36 hours of becoming aware of a “computer-security incident” or a “notification incident.” The proposed rule also would require specific and immediate notifications by bank service providers that become aware of similar incidents.

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, 2020, the Company had not been made aware of any instances of non-compliance with the guidance.

[Table of Contents](#)

CARES Act. In response to the COVID-19 pandemic, President Trump signed into law the CARES Act on March 27, 2020. Among other things, the CARES Act included the following provisions impacting financial institutions:

- **Community Bank Leverage Ratio.** The CARES Act directs federal bank regulators to adopt interim final rules to lower the threshold under the CBLR from 9% to 8% and to provide a reasonable grace period for a community bank that falls below the threshold to regain compliance, in each case until the earlier of the termination date of the national emergency or December 31, 2020. In April 2020, the federal bank regulators issued two interim final rules implementing this directive. One interim final rule provides that, as of the second quarter 2020, banking organizations with leverage ratios of 8% or greater (and that meet the other existing qualifying criteria) may elect to use the CBLR framework. It also establishes a two-quarter grace period for qualifying community banking organizations whose leverage ratios fall below the 8% CBLR requirement, so long as the banking organization maintains a leverage ratio of 7% or greater. The second interim final rule provides a transition from the temporary 8% CBLR requirement to a 9% CBLR requirement. It establishes a minimum CBLR of 8% for the second through fourth quarters of 2020, 8.5% for 2021, and 9% thereafter, and maintains a two-quarter grace period for qualifying community banking organizations whose leverage ratios fall no more than 100 basis points below the applicable CBLR requirement.
- **Temporary Troubled Debt Restructurings (TDR) Relief.** The CARES Act allows banks to elect to suspend requirements under GAAP for loan modifications related to the COVID-19 pandemic (for loans that were not more than 30 days past due as of December 31, 2019) that would otherwise be categorized as a TDR, including impairment for accounting purposes, until the earlier of 60 days after the termination date of the national emergency or December 31, 2020. Federal banking regulators are required to defer to the determination of the banks making such suspension. The Consolidated Appropriations Act, 2021, signed into law on December 27, 2020, extended this temporary relief until the earlier of 60 days after the termination date of the national emergency or January 1, 2022.
- **Small Business Administration (SBA) Paycheck Protection Program.** The CARES Act created the SBA's Paycheck Protection Program. Under the Paycheck Protection Program, funds were authorized for small business loans to pay payroll and group health costs, salaries and commissions, mortgage and rent payments, utilities, and interest on other debt. The loans are provided through participating financial institutions, including the Bank, that process loan applications and service the loans.

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.

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 are difficult to predict, and could have a material, adverse effect on the business, financial condition and results of operations of the Company and the Bank.

[Table of Contents](#)

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 ongoing COVID-19 pandemic and measures intended to prevent its spread may adversely affect the Company's business, financial condition and operations; the extent of such impacts are highly uncertain and difficult to predict.

Global health and economic concerns relating to the COVID-19 outbreak and government actions taken to reduce the spread of the virus have had a material adverse impact on the macroeconomic environment, and the outbreak has significantly increased economic uncertainty. The pandemic has resulted in federal, state and local authorities, including those who govern the markets in which we operate, implementing numerous measures to try to contain the virus. These measures, including shelter in place orders and business limitations and shutdowns, have significantly contributed to rising unemployment and negatively impacted consumer and business spending.

The COVID-19 outbreak has adversely impacted and is likely to continue to adversely impact the Company's workforce and operations and the operations of its customers and business partners. In particular, the Company may experience adverse effects due to a number of operational factors impacting it or its customers or business partners, including but not limited to:

- credit losses resulting from financial stress experienced by the Company's borrowers, especially those operating in industries most hard hit by government measures to contain the spread of the virus;
- operational failures, disruptions or inefficiencies due to changes in the Company's normal business practices necessitated by its internal measures to protect its employees and government-mandated measures intended to slow the spread of the virus;
- possible business disruptions experienced by the Company's vendors and business partners in carrying out work that supports its operations;
- decreased demand for the Company's products and services due to economic uncertainty, volatile market conditions and temporary business closures;
- any financial liability, credit losses, litigation costs or reputational damage resulting from the Company's origination of PPP loans; and
- heightened levels of cyber and payment fraud, as cyber criminals try to take advantage of the disruption and increased online activity brought about by the pandemic.

The extent to which the pandemic impacts the Company's business, liquidity, financial condition and operations will depend on future developments, which are highly uncertain and are difficult to predict, including, but not limited to, its duration and severity, the actions to contain it or treat its impact, and how quickly and to what extent normal economic and operating conditions can resume. In addition, the rapidly changing and unprecedented nature of COVID-19 heightens the inherent uncertainty of forecasting future economic conditions and their impact on the Company's loan portfolio, thereby increasing the risk that the assumptions, judgments and estimates used to determine the allowance for loan losses and other estimates are incorrect. During the fourth quarter of 2020, the Bank modified certain loan agreements to provide payment relief to its customers experiencing business interruptions from the pandemic by providing interest only payments for periods ranging between 6 and 24 months. The extent of asset quality deterioration that could result from the modified loans may be impacted by the continuation of customers' business interruptions beyond the modification periods. As a result of these and other conditions, the ultimate impact of the pandemic is highly uncertain and subject to change, and the Company cannot predict the full extent of the impacts on its business, its operations or the global economy as a whole.

Dependence on uncontrollable economic conditions could have a material adverse impact on our financial condition and results of operations.

Like all financial institutions, we are subject to the effects of any economic downturn. Our business is concentrated in the northern Shenandoah Valley and the central regions of Virginia. As a result, our financial condition and results of operations may be affected by changes in the economies of these regions. Adverse changes in economic conditions in our market areas would likely impair the ability to collect loans, increase problem assets and foreclosures, decrease demand for banking products and services, deteriorate the value of collateral for loans, and could otherwise have a material adverse effect on our financial condition and results of operations. As a result, a deterioration in economic conditions may have a negative effect on our financial conditions and results of operations.

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.

[Table of Contents](#)

Difficulties in combining the operations of new or 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 opening a new branch or through an acquisition. Inherent uncertainties exist in integrating the operations of a new or acquired entity or acquired branches. In addition, the markets and industries in which the Company and its potential new branch locations or acquisition targets operate may be 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 a new branch location or 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 new branch locations or 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.

Strong competition in our primary market area may limit asset growth and profitability.

We encounter strong competition from other financial institutions in our primary market area. In addition, established financial institutions not already operating in our primary market area may open branches at future dates. In the conduct of certain aspects of our business, we also compete with credit unions, mortgage banking companies, consumer finance companies, insurance companies, real estate companies, Fintech, and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon us. Many of these competitors have substantially greater resources and lending limits than we have and offer services that we do not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. Finally, these institutions may have differing pricing and underwriting standards, which may adversely affect our company through the loss of business or causing a misalignment in our risk-return relationship. No assurance can be given that such competition will not have an adverse impact on the 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 Company's fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Company'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.

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.

Loss of any of our key personnel could disrupt our operations and result in reduced revenues or increased expenses.

We are a relationship-driven organization. A key aspect of our business strategy is for our senior officers to have primary contact with our customers. Our growth and development to date have been, in large part, a result of these personalized relationships with our customer base.

Our senior officers have considerable experience in the banking industry and related financial services and are extremely valuable and would be difficult to replace. The loss of the services of these officers could have a material adverse effect upon future prospects. Although we have entered into employment contracts with certain senior officers, we cannot offer any assurance that they and other key employees will remain employed by us. The unexpected loss of services of one or more of these key employees could have a material adverse effect on operations and possibly result in reduced revenues or increased 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 the Company's 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 the Company's actual or alleged conduct in any number of activities, including lending practices, the failure of any product or service sold by it to meet its 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 the Company's ability to keep, attract and/or retain customers and can expose it to litigation and regulatory action. Negative public opinion could also affect the Company's ability to borrow funds in the unsecured wholesale debt markets.

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.

Loss of deposits or a change in deposit mix could increase our funding costs.

Deposits are a low cost and stable source of funding. We compete with banks and other financial institutions for deposits. Funding costs may increase because we may lose deposits and replace them with more expensive sources of funding, clients may shift their deposits into higher cost products or we may need to raise interest rates to avoid losing deposits. Higher funding costs reduce our net interest margin, net interest income and net income.

[Table of Contents](#)

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 Company 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.

Liquidity could be impaired by an inability to access the capital markets or an unforeseen outflow of cash.

Liquidity is essential to our businesses. Due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or the Company, our liquidity could be impaired by an inability to access the capital markets or an unforeseen outflow of cash or deposits which could constrain our ability to make new loans or meet our existing commitments to loan and deposit customers and could ultimately jeopardize our overall liquidity and capitalization.

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.

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 relies on other companies to provide key components of its business infrastructure.

Third parties provide key components of the Company'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 operational functions of business counterparties over which the Company may have limited or no control may experience disruptions that could adversely impact the Company.

Every year, retailers and service providers are the target of data systems incursions which result in the thefts of credit and debit card information, online account information, and other financial data of their customers and users. These incursions affect cards issued and deposit accounts maintained by many banks, including the Company. Although our systems are not breached in such incursions, these events can cause the Company to reissue a significant number of cards and take other costly steps to avoid significant theft loss to the Company and its customers. In some cases, the Company may be required to reimburse customers for the losses they incur. Other possible points of intrusion or disruption not within the Company'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.

[Table of Contents](#)

Security breaches and other disruptions could compromise our information and expose us to liability or result in the loss of money, which could damage our reputation and our business.

We rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. While we have policies and procedures designed to prevent or limit the effect of a possible security breach, our computer systems, software, and networks may be vulnerable to unauthorized access, computer viruses, or other malicious code, and other events that could have a security impact. To date, the Company has not experienced a significant compromise, significant data loss or any material financial losses related to cybersecurity attacks, but the Company's systems and those of its customers and third-party service providers are under constant threat and it is possible that the Company could experience a significant event in the future. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as due to the expanding use of Internet banking, mobile banking and other technology-based products and services by the Company and its customers. If one or more such events occur, this potentially could jeopardize our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our or our customers' operations, or result in the loss of money. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us.

Security breaches in our internet banking activities could further expose us to possible liability, financial loss, and damage to our reputation. Any compromise of our security also could deter customers from using our internet banking services that involve the transmission of confidential information. We have implemented security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures, which could result in damage to our reputation and our business.

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

Nonperforming assets adversely affect the Company 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, which may reduce the amount of liquidity available to the Company and require a higher level of capital 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 increases in nonperforming assets in the future.

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

Like all financial institutions, the Company maintains an allowance for loan losses to provide for loans that its borrowers may not repay in their entirety. The Company 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 Company's borrowers to execute their business models successfully through changing economic environments, competitive challenges, and other factors complicate the Company'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 Company 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.

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

The Company 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 Company's loans are secured by real estate (both residential and commercial) in the Company'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 Company. Risks of loan defaults and foreclosures are unavoidable in the banking industry; the Company tries to limit its exposure to these risks by monitoring extensions of credit carefully. The Company 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.

[Table of Contents](#)

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

The Company'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 Company'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 Company's financial condition.

The Company'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 Company's results of operations.

The Company'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 Company's financial condition.

Although most of the Company's construction and development loans are secured by real estate, the Company 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 Company 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 Company'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.

Although the Company emphasizes local lending practices, the Company purchases certain loans through a third-party lending program. These portfolios include consumer loans and carry risks associated with the borrower, changes in the economic environment, and the vendor themselves. The Company manages these risks through policies that require minimum credit scores and other underwriting requirements, robust analysis of actual performance versus expected performance, as well as ensuring compliance with the Company's vendor management program. While these policies are designed to manage the risks associated with these loans, there can be no assurance that such measures will be effective in avoiding undue credit losses.

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.

[Table of Contents](#)

The Company 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 Company is forced to foreclose upon such loans.

A significant portion of the Company's loan portfolio consists of loans secured by real estate. The Company 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 Company'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 Company may not be able to recover the outstanding balance of the loan.

The Company 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 Company 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 banking organizations, such as the Bank, that are based on the Basel III regulatory capital reforms. These stricter capital requirements were fully-implemented on January 1, 2019. While the Economic Growth Act and recent federal banking regulations established a simplified leverage capital framework for smaller banks, 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 Company fails to meet these minimum capital guidelines and/or other regulatory requirements, the Company's financial condition could be materially and adversely affected.

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 could include higher capital requirements, and 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, referred to as CECL, was finalized in June 2016. The standard will be effective for the Company beginning January 1, 2023. To implement the new standard, the Company will incur costs related to data collection and documentation, technology and training. For additional information, see "Recent Accounting Pronouncements" included in Note 1 to the Consolidated Financial Statements included in this Form 10-K. If the Company is required to materially increase the level of the allowance for loan losses or incurs additional expenses to determine the appropriate level of the allowance for loan losses, such changes could adversely affect the Company's capital levels, financial condition and results of operations.

[Table of Contents](#)

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.

The Company may be required to transition from the use of the London Interbank Offered Rate (LIBOR) index in the future.

The Company has certain variable-rate loans indexed to LIBOR to calculate the loan interest rate. The United Kingdom Financial Conduct Authority, which regulates LIBOR, has previously announced that the continued availability of the LIBOR on the current basis is not guaranteed after 2021. In November 2020, the administrator of LIBOR announced it will consult on its intention to extend the retirement date of certain offered rates whereby the publication of the one week and two month LIBOR offered rates will cease after December 31, 2021; but, the publication of the remaining LIBOR offered rates will continue until June 30, 2023. Given consumer protection, litigation, and reputation risks, federal bank regulators have indicated that entering into new contracts that use LIBOR as a reference rate after December 31, 2021, would create safety and soundness risks and that they will examine bank practices accordingly. Therefore, the agencies encouraged banks to cease entering into new contracts that use LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.

It is difficult to predict whether and to what extent banks will continue to provide LIBOR submissions to the administrator of LIBOR or whether any additional reforms to LIBOR may be enacted in the United Kingdom or elsewhere. At this time, no consensus exists as to what rate or rates may become acceptable alternatives to LIBOR, and it is impossible to predict the effect of any such alternatives on the value of LIBOR-based variable-rate loans, as well as LIBOR-based securities, subordinated notes, trust preferred securities, or other securities or financial arrangements. The transition to alternative reference rate for new contracts, or the implementation of a substitute index or indices for the calculation of interest rates under the Company's existing loan agreements with borrowers or other financial arrangements, could change the Company's market risk profile, interest margin, interest spread and pricing models, may cause the Company to incur significant expenses in effecting the transition, may result in reduced loan balances if borrowers do not accept a substitute index or indices, and may result in disputes or litigation with customers or other counter-parties over the appropriateness or comparability to LIBOR of the substitute index or indices, any of which could have a material adverse effect on the Company's results of operations.

We are subject to environmental liability risk associated with our lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Environmental reviews of real property before initiating foreclosure actions may not be sufficient to detect all potential environmental hazards. Remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

Severe weather, pandemics, natural disasters, acts of war or terrorism, and other external events could significantly impact our business.

Severe weather, pandemics, natural disasters, and other environmental risks, acts of war or terrorism, and other adverse external events could have a significant impact on our ability to conduct business. In addition, such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue, and/or cause us to incur additional expenses. The occurrence of any such event in the future could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

[Table of Contents](#)

The Company's wealth management revenue is directly impacted by the market value of assets under management, which could adversely impact Company profitability.

A significant portion of revenue from wealth management services is based on the market value of assets under management, which may decrease due to a variety of factors including an economic slowdown. Any sustained period of lower market values of assets under management would adversely affect the Company's wealth management revenue and, as a result, would also adversely affect the Company's results of operations.

There are risks resulting from the use of models in our business.

We rely on quantitative models to measure risks and to estimate certain financial values. Models may be used in such processes as determining the pricing of various products, grading loans and extending credit, measuring interest rate and other market risks, predicting or estimating losses, assessing capital adequacy and calculating economic and regulatory capital levels, as well as to estimate the value of financial instruments and balance sheet items. Poorly designed or implemented models present the risk that our business decisions based on information incorporating model output would be adversely affected due to the inadequacy of that information. Also, information we provide to the public or to our regulators based on poorly designed or implemented models could be inaccurate or misleading.

Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.

The policies of the Federal Reserve affect us significantly. The Federal Reserve regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits and can also affect the value of financial instruments we hold. Those policies determine to a significant extent our cost of funds for lending and investing. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve could reduce the demand for a borrower's products and services. This could adversely affect the borrower's earnings and ability to repay a loan, which could have a material adverse effect on our financial condition and results of operations.

The success of our business strategies depends on our ability to identify and recruit individuals with experience and relationships in our primary markets.

The successful implementation of our business strategy will require us to continue to attract, hire, motivate and retain skilled personnel to develop new customer relationships as well as new financial products and services. The market for qualified management personnel is competitive, which has contributed to salary and employee benefit costs that have risen and are expected to continue to rise, which may have an adverse effect on the Company's net income. In addition, the process of identifying and recruiting individuals with the combination of skills and attributes required to carry out our strategy is often lengthy, and we may not be able to effectively integrate these individuals into our operations. Our inability to identify, recruit and retain talented personnel to manage our operations effectively and in a timely manner could limit our growth, which could materially adversely affect our business.

Compliance with laws, regulations and supervisory guidance, both new and existing, may adversely affect our business, financial condition and results of operations.

We are subject to numerous laws, regulations and supervision from both federal and state agencies. Failure to comply with these laws and regulations could result in financial, structural and operational penalties, including receivership. In addition, establishing systems and processes to achieve compliance with these laws and regulations may increase our costs and/or limit our ability to pursue certain business opportunities.

Laws and regulations, and any interpretations and applications with respect thereto, generally are intended to benefit consumers, borrowers and depositors, but not stockholders. The legislative and regulatory environment is beyond our control, may change rapidly and unpredictably and may negatively influence our revenues, costs, earnings, and capital levels. Our success depends on our ability to maintain compliance with both existing and new laws and regulations.

With the incoming Biden administration, a Democratic controlled Congress, and changes in leadership at federal agencies such as the CFPB, we expect that financial institutions will remain heavily regulated in the near future and that additional laws or regulations may be adopted further regulating specific banking practices. Future legislation, regulation and government policy could affect the banking industry as a whole, including the Company's business and results of operations, in ways that are difficult to predict. In addition, the Company's results of operations could be adversely affected by changes in the way in which existing statutes and regulations are interpreted or applied by courts and government agencies.

The CFPB may increase our regulatory compliance burden and could affect the consumer financial products and services that we offer.

Among the Dodd-Frank Act's significant regulatory changes, it created a new financial consumer protection agency, the CFPB. The CFPB is reshaping the consumer financial laws through rulemaking and enforcement of the Dodd-Frank Act's prohibitions against unfair, deceptive and abusive consumer finance products or practices, which are directly affecting the business operations of financial institutions offering consumer financial products or services. This agency's broad rulemaking authority includes identifying practices or acts that are unfair, deceptive or abusive in connection with any consumer financial transaction, financial product or service. Although the CFPB has jurisdiction over banks with \$10 billion or greater in assets, rules, regulations and policies issued by the CFPB may also apply to the Company or its subsidiaries by virtue of the adoption of such policies and best practices by the Federal Reserve and the FDIC. Further, the CFPB may include its own examiners in regulatory examinations by the Company's primary regulators. The total costs and limitations related to this additional regulatory agency and the limitations and restrictions that will be placed upon the Company with respect to its consumer product and service offerings have yet to be determined in their entirety. However, these costs, limitations and restrictions may produce significant, material effects on our business, financial condition and results of operations.

[Table of Contents](#)

Risks Related to the Acquisition of Fincastle

Combining Fincastle into the Company may be more difficult, costly or time-consuming than we expect.

The success of the Merger will depend, in part, on the Company's ability to realize the anticipated benefits and cost savings from combining the business of Fincastle into the business of the Company without materially disrupting the existing customer relationships of Fincastle or the Company. If the Company is not able to achieve these objectives, the anticipated benefits and cost savings of the Merger may not be realized fully, or at all, or may take longer to realize than expected.

The success of the Merger will depend, in part, on the Company's ability to successfully combine the businesses of the Company and Fincastle. To realize these anticipated benefits, the Company will integrate Fincastle's business into its own. The integration process in the Merger could result in the disruption of ongoing business, inconsistencies in standards, controls, procedures, and policies that affect adversely the Company's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the Merger. If the Company experiences difficulties with the integration process, the anticipated benefits of the Merger may not be realized, fully or at all, or may take longer to realize than expected. As with any merger of financial institutions, there also may be disruptions that cause the Company to lose customers or cause customers to withdraw their deposits from Fincastle or the Bank, or other unintended consequences that could have a material adverse effect on the Company's results of operations or financial condition after the Merger. These integration matters could have an adverse effect on the Company for an indeterminate period after consummation of the Merger.

The Company may not be able to effectively integrate the operations of Fincastle into the Bank.

The future operating performance of the Company and the Bank will depend, in part, on the success of the merger of Fincastle with and into the Bank. The success of the subsidiary bank merger will, in turn, depend on a number of factors, including the Company's ability to (i) integrate the operations and branches of Fincastle and the Bank, (ii) retain the deposits and customers of Fincastle and the Bank, (iii) control the incremental increase in noninterest expense arising from the Merger in a manner that enables the combined bank to improve its overall operating efficiencies, and (iv) retain and integrate the appropriate personnel of Fincastle into the operations of the Bank, and reduce overlapping bank personnel. The integration of Fincastle and the Bank will require the dedication of the time and resources of the Bank's management and may temporarily distract management's attention from the day-to-day business of the Bank. If the Bank is unable to successfully integrate Fincastle, the Bank may not be able to realize expected operating efficiencies and eliminate redundant costs.

Regulatory approvals may not be received, may take longer than expected, or may impose conditions that are not presently anticipated or that could have an adverse effect on the combined company following the Merger.

Before the Merger may be completed, the Company and the Bank must obtain approvals from the Federal Reserve and the SCC. Other approvals, waivers or consents from regulators may also be required. These regulators may impose conditions on the completion of the Merger or require changes to the terms of the Merger. Such conditions or changes and the process of obtaining regulatory approvals could have the effect of delaying completion of the Merger and the subsidiary bank merger, imposing additional costs on the combined company or limiting the revenues of the combined company, any of which might have an adverse effect on the combined company following the Merger.

A significant delay in the completion of the Merger could have a material adverse effect on the Company and Fincastle as a combined company.

The merger agreement with Fincastle is subject to a number of conditions that must be fulfilled in order to complete the Merger. Those conditions include, among others: (1) approval of the Merger by the Company's and Fincastle's shareholders, (2) receipt of all required approvals from bank regulatory authorities and expiration of all applicable waiting periods, (3) absence of any law or order prohibiting or restricting the completion of the Merger, and (4) effectiveness of the Company's registration statement filed with the SEC. Certain costs relating to the Merger, such as legal, accounting and financial advisory fees, must be paid even if the Merger is not completed. If the Merger is not completed, we would have to recognize these expenses and our management would have committed substantial time and resources without realizing the expected benefits of the Merger.

If these conditions to the completion of the Merger are not fulfilled when expected and, as a result, the completion of the Merger is delayed, the diversion of management attention from pursuing other opportunities, the constraints in the merger agreement on the ability to make significant changes to each company's ongoing business during the pendency of the Merger, the incurrence of additional merger related expenses, and other market and economic factors could have a material adverse effect on the combined company's business, financial condition and results of operations.

The Company and Fincastle will be subject to business uncertainties and contractual restrictions while the Merger is pending.

Uncertainty about the effect of the Merger on employees and customers may have an adverse effect on the Company and Fincastle. These uncertainties may impair the Company's and Fincastle's ability to attract, retain and motivate key personnel until the Merger is completed, and could cause customers and others that deal with the Company and Fincastle to seek to change existing business relationships with the Company and Fincastle. Retention of certain employees by the Company and Fincastle may be challenging while the Merger is pending, as certain employees may experience uncertainty about their future roles with the Company or Fincastle. If key employees depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the Company or Fincastle, the Company's or Fincastle's business, or the business of the combined company following the Merger, could be harmed. In addition, subject to certain exceptions, the Company and Fincastle have each agreed to operate its business in the ordinary course prior to closing and refrain from taking certain specified actions until the Merger occurs, which may prevent Fincastle from pursuing attractive business opportunities that may arise prior to the completion of the Merger.

[Table of Contents](#)

Risks Related To The Company's Securities

The Company relies on dividends from its subsidiaries for substantially all of its revenue.

The Company is a bank holding company that conducts substantially all of its operations through the Bank. As a result, the Company relies on dividends from the Bank for substantially all of its revenues. There are various regulatory restrictions on the ability of the Bank to pay dividends or make other payments to the Company. Also, the Company's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event the Bank is unable to pay dividends to the Company, the Company may not be able to service debt, pay obligations, or pay a cash dividend to the holders of its common stock and the Company's business, financial condition, and results of operations may be materially adversely affected. Further, 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 even if the Bank continues to pay dividends to the Company.

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.

Current economic conditions or other factors 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 its common stock, which may limit its ability to pay dividends on common stock in the future.

The Company's ability to pay dividends on common stock is also limited by contractual restrictions under its 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.

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.

[Table of Contents](#)

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, 2020, the Bank operated 14 branches throughout the Shenandoah Valley and the central Virginia regions. The Bank also operates a loan production office and a customer service center in a retirement community in the Shenandoah Valley region. 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, "Nature of Banking Activities and 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.

Part II

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

Market Information and Holders

Shares of the common stock of the Company are traded on the Nasdaq Capital Market stock exchange under the symbol "FXNC." As of March 19, 2021 the Company had 521 shareholders of record and approximately 754 additional beneficial owners of shares of common stock.

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 its common stock, which may limit the Company's 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.

Issuer Purchases of Equity Securities

During the fourth quarter of 2019, the Board of Directors of the Company authorized a stock repurchase plan pursuant to which the Company may have repurchased up to \$5.0 million of its outstanding common stock. Repurchases under the plan could have been made through privately negotiated transactions or in the open market in accordance with SEC rules. The Company's Board of Directors authorized the purchase plan through December 31, 2020, unless the entire amount authorized to be repurchased had been acquired before that date. As of December 31, 2020, the Company made aggregate common stock repurchases of 129,035 shares for an aggregate cost of \$2.1 million under the purchase plan. The Company has not authorized another stock repurchase plan due to the potential impact of the pandemic on the economy and the Bank's customers.

The Company had no purchases of its common stock during the three months ended December 31, 2020 pursuant to the stock repurchase plan.

[Table of Contents](#)
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,				
	2020	2019	2018	2017	2016
Results of Operations					
Interest and dividend income	\$ 32,851	\$ 32,897	\$ 31,138	\$ 27,652	\$ 25,237
Interest expense	3,383	4,887	3,512	2,386	1,982
Net interest income	29,468	28,010	27,626	25,266	23,255
Provision for loan losses	3,000	450	600	100	—
Net interest income after provision for loan losses	26,468	27,560	27,026	25,166	23,255
Noninterest income	8,225	8,552	9,157	8,292	8,493
Noninterest expense	23,786	24,318	23,761	23,284	23,488
Income before income taxes	10,907	11,794	12,422	10,174	8,260
Income tax expense	2,049	2,238	2,287	3,726	2,353
Net income	\$ 8,858	\$ 9,556	\$ 10,135	\$ 6,448	\$ 5,907
Key Performance Ratios					
Return on average assets	0.98 %	1.23 %	1.34 %	0.89 %	0.84 %
Return on average equity	10.92 %	13.19 %	16.36 %	11.57 %	12.00 %
Net interest margin (1)	3.50 %	3.88 %	3.93 %	3.77 %	3.61 %
Efficiency ratio (1)	62.52 %	65.28 %	63.05 %	66.42 %	71.05 %
Dividend payout	24.23 %	18.70 %	9.78 %	10.73 %	10.01 %
Equity to assets	8.93 %	9.65 %	8.85 %	7.87 %	7.28 %
Per Common Share Data					
Net income, basic	\$ 1.82	\$ 1.92	\$ 2.05	\$ 1.30	\$ 1.20
Net income, diluted	1.82	1.92	2.04	1.30	1.20
Cash dividends	0.44	0.36	0.20	0.14	0.12
Book value at period end	17.47	15.54	13.45	11.76	10.58
Financial Condition					
Assets	\$ 950,932	\$ 800,048	\$ 752,969	\$ 739,110	\$ 716,000
Loans, net	622,429	569,412	537,847	516,875	480,746
Securities	156,334	140,416	144,953	139,033	149,748
Deposits	842,461	706,442	670,566	664,980	645,570
Shareholders' equity	84,916	77,219	66,674	58,154	52,151
Average shares outstanding, diluted	4,880	4,968	4,956	4,944	4,928
Capital Ratios (2)					
Leverage	8.80 %	10.13 %	9.26 %	8.46 %	8.48 %
Risk-based capital ratios:					
Common equity Tier 1 capital	14.57 %	13.99 %	12.71 %	12.09 %	12.38 %
Tier 1 capital	14.57 %	13.99 %	12.71 %	12.09 %	12.38 %
Total capital	15.82 %	14.84 %	13.62 %	13.12 %	13.47 %

(1) This performance ratio is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational performance. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes 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. See "Non-GAAP Financial Measures" included in Item 7 of this Form 10-K.

(2) All capital ratios reported are for the Bank.

[Table of Contents](#)

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, 2020 and 2019 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 and, together with Trust II, the Trusts)

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 offers loan, deposit, and wealth management products and services. Loan products and services include consumer loans, residential mortgages, home equity loans, and commercial loans. Deposit products and services include checking accounts, treasury management solutions, savings accounts, money market accounts, certificates of deposit, and individual retirement accounts. Wealth management services include estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. Customers include small and medium-sized businesses, individuals, estates, local governmental entities, and non-profit organizations. 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, central regions of Virginia, and the city of Richmond. Within this market area, there are diverse types of industry including medical and professional services, manufacturing, retail, warehousing, Federal government, hospitality, and higher education.

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

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.

Primary expense categories are salaries and employee benefits, which comprised 56% of noninterest expenses during 2020, followed by occupancy and equipment expense, which comprised 14% of noninterest expenses. The provision for loan losses is also 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.

[Table of Contents](#)

COVID-19 Pandemic Update

Operations

During the fourth quarter of 2020, the Bank continued to follow its Pandemic Plan that strives to protect the health of its employees and customers, while continuing to deliver essential banking services. In response to an increasing number of COVID-19 cases in our communities during the fourth quarter, the Bank re-entered phase one of its plan on December 9, 2020 after operating under phase two of its plan since July 1, 2020. Phase one of the plan limits access to banking offices while delivering a majority of its banking services through branch drive throughs, ATMs, and mobile and internet banking platforms.

Paycheck Protection Program

The Bank participated as a lender in the U.S. Small Business Administration's (SBA) Paycheck Protection Program (PPP) to support local small businesses and non-profit organizations during 2020. During the second and third quarters, the Bank originated \$76.6 million of PPP loans, received \$2.5 million of loan fees, and incurred \$535 thousand of loan origination costs. The original PPP provided forgivable loans over a five-month period before it stopped accepting applications in August of 2020. The loan fees are being accreted into earnings evenly over the life of the loans, net of the loan costs, through interest and fees on loans. At December 31, 2020, PPP loan balances totaled \$64.7 million with approximately 99% of the loan balances maturing in the second quarter of 2022 and approximately 1% of loan balances maturing in the second quarter of 2025. PPP loans to customers who had requested debt forgiveness and were waiting to be notified of forgiveness decisions from the SBA totaled \$2.0 million at December 31, 2020.

Congress revived the PPP (new PPP) as part of the COVID-19 relief bill that was signed into law on December 27, 2020. The Bank began participating as a lender in the new PPP in January of 2021. As of February 28, 2021, the Bank had originated \$18.9 million of new PPP loans. Loan fees received on new PPP loans will also be accreted into earnings evenly over the life of the loans, net of the loan costs, through interest and fees on loans. These new PPP loans will mature in the first quarter of 2026.

Asset Quality Impact

The pandemic has negatively impacted the financial condition of certain loan customers. The Bank expects certain sectors of its commercial real estate loan portfolio, including retail shopping, lodging and leisure, may experience elevated financial pressure in future periods. Those sectors comprised 5%, 5% and 2% of the loan portfolio, respectively, excluding PPP loans, at December 31, 2020. The Bank also expects that loans in those same sectors of its commercial and industrial loan portfolio may experience financial pressure in future periods. The magnitude of the potential decline in the Bank's loan quality in future periods will likely depend on the duration of the pandemic and the extent that the Bank's customers experience business interruptions.

Loan Modifications

In response to the unknown impact of the pandemic on the economy and its customers, the Bank created and implemented a loan payment deferral program for individual and business customers beginning in the first quarter of 2020, which provided them the opportunity to defer monthly payments for 90 days. At June 30, 2020, loans participating in the program totaled \$182.6 million. More than 99% of these loans resumed regular payments during the second half of the year after their deferral periods ended. Loans that remained in the program totaled \$1.2 million at December 31, 2020. These loans were not considered troubled debt restructurings (TDRs) because they were modified in accordance with relief provisions of the CARES Act and recent interagency regulatory guidance.

During the fourth quarter of 2020, the Bank modified terms of certain loans for customers that continued to be negatively impacted by the pandemic. The loan modifications lowered borrower loan payments by allowing interest only payments for periods ranging between 6 and 24 months. All loans modified were in the Bank's commercial real estate loan portfolio and totaled \$14.3 million at December 31, 2020. The loans were comprised of \$12.8 million in the lodging sector and \$1.5 million in the leisure sector. These loans were not considered TDRs because they were modified in accordance with relief provisions of the CARES Act.

Capital

The Company issued \$5.0 million of subordinated debt in June 2020 as a result of its enterprise risk management and capital planning. The purpose of the issuance was primarily to further strengthen holding company liquidity and to remain a source of strength for the Bank in the event of a severe economic downturn. The Company may also use the proceeds of the issuance for general corporate purposes, including the potential repayment of the Company's existing subordinated debt issued in 2015, which became callable on a quarterly basis beginning January 1, 2021. The subordinated debt issued in 2020 consists of a 5.50% fixed-to-floating rate subordinated note due 2030 issued to an institutional investor and was structured to qualify as Tier 2 capital under bank regulatory guidelines.

The Company's stock repurchase plan remained suspended during the fourth quarter of 2020 and ended on December 31, 2020. The Company has not authorized another stock repurchase plan due to the potential impact of the pandemic on the economy and the Bank's customers. The Company continued to pay cash dividends on common stock of \$0.11 per share during each quarter of 2020.

[Table of Contents](#)

Overview of Financial Performance and Condition

Net income decreased by \$698 thousand to \$8.9 million, or \$1.82 per diluted share, for the year ended December 31, 2020, compared to \$9.6 million, or \$1.92 per diluted share, for the same period in 2019. Return on average assets was 0.98% and return on average equity was 10.92% for the year ended December 31, 2020, compared to 1.23% and 13.19%, respectively, for the year ended December 31, 2019.

The \$698 thousand decrease in net income for the year ended December 31, 2020 resulted primarily from a \$2.6 million increase in provision for loan losses and a \$327 thousand, or 4%, decrease in noninterest income, compared to the same period of 2019. These unfavorable variances were partially offset by a \$1.5 million, or 5%, increase in net interest income and a \$532 thousand, or 2%, decrease in noninterest expenses.

Net interest income increased primarily from a decrease in interest expense on deposits, which was attributable to reductions in interest rates paid. Average earning asset balances increased 16%, while the net interest margin decreased 38 basis points to 3.50% for the year ended December 31, 2020, compared to 3.88% for the same period in 2019. Noninterest income decreased primarily from lower service charges on deposit accounts, which was partially offset by higher amounts of wealth management fees and fees for other customer services. Noninterest expense decreased primarily from lower salaries and employee benefits expense, marketing expense, and other operating expense, which were partially offset by higher FDIC assessment.

Based on management's analysis and the supporting allowance for loan loss calculation, a provision for loan losses of \$3.0 million was recorded during the year ended December 31, 2020, compared to a provision for loan losses of \$450 thousand during the year ended December 31, 2019. The increase in provision for loan losses was attributable to increases in both the general and specific reserve components of the allowance for loan losses.

For a more detailed discussion of the Company's performance, see "Net Interest Income," "Provision for Loan Losses," "Noninterest Income," "Noninterest Expense" and "Income Taxes" below.

Acquisition of The Bank of Fincastle

On February 18, 2021, the Company entered into an agreement to acquire Fincastle for an aggregate purchase price of approximately \$31.6 million of cash and stock. The Company expects to complete the acquisition in the third quarter of 2021. With the addition of Fincastle, the Company would have had approximately \$1.2 billion in assets, \$868.0 million in total gross loans outstanding and \$1.0 billion in total deposits on a combined basis at December 31, 2020. After the acquisition is completed, the former Fincastle branches will continue to operate as The Bank of Fincastle, a division of First Bank, until the systems conversion is expected to be completed in the fourth quarter of 2021. The Company did not incur any merger related expenses for the year ended December 31, 2020 in connection with its acquisition of Fincastle. The Company estimates that it will incur aggregate pre-tax merger related costs of approximately \$4.2 million during 2021.

Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO expense, amortization of intangibles, and gains/(losses) on disposal of premises and equipment, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities gains. 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 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	
	2020	2019
Noninterest expense	\$ 23,786	\$ 24,318
Subtract: other real estate owned expense, net	—	(1)
Subtract: amortization of intangibles	(151)	(302)
Add/(Subtract): gains/(losses) on disposal of premises and equipment, net	29	(14)
	\$ 23,664	\$ 24,001
Tax-equivalent net interest income	\$ 29,666	\$ 28,217
Noninterest income	8,225	8,552
Subtract: securities gains, net	(40)	(1)
	\$ 37,851	\$ 36,768
Efficiency ratio	62.52 %	65.28 %

[Table of Contents](#)

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 2020 and 2019 is 21%. 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	
	2020	2019
GAAP measures:		
Interest income - loans	\$ 29,497	\$ 28,958
Interest income - investments and other	3,354	3,939
Interest expense - deposits	(2,589)	(4,104)
Interest expense - federal funds purchased	—	(1)
Interest expense – subordinated debt	(501)	(360)
Interest expense – junior subordinated debt	(293)	(420)
Interest expense - other borrowings	—	(2)
Total net interest income	\$ 29,468	\$ 28,010
Non-GAAP measures:		
Tax benefit realized on non-taxable interest income - loans	\$ 34	\$ 40
Tax benefit realized on non-taxable interest income - municipal securities	164	167
Total tax benefit realized on non-taxable interest income	\$ 198	\$ 207
Total tax-equivalent net interest income	\$ 29,666	\$ 28,217

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 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 to the Consolidated Financial Statements included 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 the Company's 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.

Table of Contents

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, if any. Consumer loans are typically either unsecured or secured by rapidly depreciating assets such as automobiles. These loans are also likely to be immediately and adversely affected by job loss, divorce, illness, personal bankruptcy, or other changes in circumstances. Other loans included in this category include loans to states and political subdivisions.

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 typically 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 included in this Form 10-K.

[Table of Contents](#)

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 five directors, four 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 employees, real estate professionals, and customers. Commercial real estate loan originations and commercial and industrial loan originations are primarily 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. The Bank also participates in commercial real estate loans and commercial and industrial loans originated by other financial institutions that are typically outside its market area. In addition, the Bank has purchased consumer loans originated by other financial institutions that are typically outside its market area. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines depending on the type of loan involved. Except for loan participations with other financial institutions, 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, 2020, commitments to extend credit, stand-by letters of credit, and rate lock commitments totaled \$136.0 million.

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 mature in one year. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction and land development loans sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction and land development 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 this type of lending, the Bank generally limits loan amounts relative to the appraised value and/or cost of the collateral, analyzes the cost of the project and the creditworthiness of its borrowers, and monitors construction progress. 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.

[Table of Contents](#)

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 mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank also originates and retains certain mortgage loans in its loan portfolio.

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, office and retail buildings, hotels, industrial buildings, and religious facilities. Commercial real estate loan originations are primarily 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 and industrial loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business. The loans may be unsecured or 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, any collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much reliability as real estate.

Also included in this category are loans originated under the SBA's PPP. PPP loans are fully guaranteed by the SBA, and in some cases borrowers may be eligible to obtain forgiveness of the loans, in which case loans would be repaid by the SBA.

Consumer Lending

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

The underwriting standards employed by the Bank for consumer loans include a determination of the applicant's payment history on other debts and an assessment of ability to meet existing obligations and payments on a proposed loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment, and additionally from any verifiable secondary income.

Also included in this category are loans purchased through a third-party lending program. These portfolios include consumer loans and carry risks associated with the borrower, changes in the economic environment, and the vendor itself. The Company manages these risks through policies that require minimum credit scores and other underwriting requirements, robust analysis of actual performance versus expected performance, as well as ensuring compliance with the Company's vendor management program.

[Table of Contents](#)

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 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 expense.

Net Interest Income

For the year ended December 31, 2020, net interest income increased \$1.5 million, or 5%, to \$29.5 million, compared to \$28.0 million for the same period in 2019. The increase resulted from a \$1.5 million, or 31%, decrease in total interest expense. Total interest and dividend income, on a taxable-equivalent basis, decreased \$55 thousand to \$33.0 million, compared to \$33.1 million for 2019. The net interest margin decreased 38 basis points to 3.50% for the year ended December 31, 2020, compared to 3.88% for the same period in 2019. Growth in average earning assets of \$118.8 million, or 16%, was partially offset by the decrease in the net interest margin.

The decrease in total interest expense resulted primarily from a \$1.5 million, or 37%, decrease in interest expense on deposits, which was attributable to reduced interest rates paid on deposits. A 36 basis point decrease in the cost of interest-bearing deposits was partially offset by the impact of a \$63.4 million, or 13%, increase in average interest-bearing deposits. A 49 basis point reduction in the cost of interest-bearing checking accounts and a 77 basis point reduction in the cost of money market accounts made the largest contributions to the decrease in interest expense.

The decrease in total interest and dividend income, on a taxable-equivalent basis, resulted primarily from a 65 basis point decrease in the yield on earning assets, which was mostly offset by a \$118.8 million, or 16%, increase in average earning assets. The decrease in the yield on earning assets resulted from a 25 basis point decrease in the yield on securities, a 41 basis point decrease in the yield on loans, and a 175 basis point decrease in the yield on interest-bearing deposits in banks. The loan yield was negatively impacted by PPP loans earning a 1.00% interest rate. Additionally, the mix of earning assets had an unfavorable impact on the yield on average earning assets as lower yielding interest-bearing deposits in banks increased from 3% to 10% of average earning assets.

COVID-19 Pandemic Impact on Net Interest Income

Net interest income was negatively impacted by higher levels of nonaccrual loans. Loans to customers who are not able to make their loan payments to the Bank are placed on nonaccrual status, which causes a reversal of accrued interest receivable and interest income on loans. Recognition of interest on the loans will not resume until the borrowers can once again demonstrate their ability to repay.

Net interest income may be negatively impacted in future periods by unfavorable changes in the earning asset composition and the impact of recent decreases in market rates on earning asset yields in future periods. An unfavorable change in the Company's earning asset composition could occur if a decrease in loan demand causes a reduction in loan balances, the Bank's highest yielding asset category, while balances of securities and interest-bearing deposits in banks, the Bank's lower yielding asset categories, increase.

The ability of loan customers to make loan payments and the potential of decreasing loan demand may depend on the length of time and extent the Bank's loan customers experience business interruptions from the pandemic. During 2020, the Bank modified certain loan agreements to provide payment relief to its customers by providing interest only payments for periods ranging between 6 and 24 months. The extent of asset quality deterioration that could result from the modified loans may be impacted by the continuation of customers' business interruptions beyond the modification periods.

[Table of Contents](#)

The following table provides information on average interest-earning assets and interest-bearing liabilities for the years ended December 31, 2020, 2019, and 2018, 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,								
	2020			2019			2018		
	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	\$ 81,193	\$ 190	0.23 %	\$ 25,347	\$ 503	1.98 %	\$ 30,776	\$ 539	1.75 %
Securities:									
Taxable	112,146	2,448	2.18 %	109,622	2,705	2.47 %	119,010	3,024	2.54 %
Tax-exempt (1)	27,557	781	2.83 %	27,145	795	2.93 %	26,032	773	2.97 %
Restricted	1,844	99	5.36 %	1,746	103	5.93 %	1,591	91	5.70 %
Total securities	141,547	3,328	2.35 %	138,513	3,603	2.60 %	146,633	3,888	2.65 %
Loans: (2)									
Taxable	620,250	29,367	4.73 %	559,743	28,805	5.15 %	525,396	26,707	5.08 %
Tax-exempt (1)	3,664	164	4.49 %	4,299	193	4.48 %	4,769	211	4.42 %
Total loans	623,914	29,531	4.73 %	564,042	28,998	5.14 %	530,165	26,918	5.08 %
Federal funds sold	9	—	0.10 %	2	—	1.70 %	1	—	2.04 %
Total earning assets	846,663	33,049	3.90 %	727,904	33,104	4.55 %	707,575	31,345	4.43 %
Less: allowance for loan losses	(6,137)			(4,921)			(5,032)		
Total nonearning assets	60,690			53,950			51,914		
Total assets	\$ 901,216			\$ 776,933			\$ 754,457		
Liabilities and Shareholders' Equity									
Interest-bearing deposits:									
Checking	\$ 193,870	\$ 690	0.36 %	\$ 163,408	\$ 1,381	0.85 %	\$ 159,290	\$ 1,075	0.67 %
Money market accounts	149,029	701	0.47 %	113,180	1,405	1.24 %	87,693	697	0.79 %
Savings accounts	111,693	67	0.06 %	106,934	70	0.07 %	122,497	92	0.07 %
Certificates of deposit:									
Less than \$100	59,726	453	0.76 %	66,066	479	0.73 %	73,262	393	0.54 %
Greater than \$100	50,176	677	1.35 %	51,432	763	1.48 %	48,679	497	1.02 %
Brokered deposits	579	1	0.26 %	643	6	0.91 %	389	1	0.33 %
Total interest-bearing deposits	565,073	2,589	0.46 %	501,663	4,104	0.82 %	491,810	2,755	0.56 %
Federal funds purchased	1	—	1.58 %	30	1	2.59 %	2	—	2.30 %
Subordinated debt	7,527	501	6.65 %	4,974	360	7.23 %	4,957	360	7.26 %
Junior subordinated debt	9,279	293	3.16 %	9,279	420	4.53 %	9,279	397	4.28 %
Other borrowings	—	—	— %	41	2	6.21 %	6	—	2.47 %
Total interest-bearing liabilities	581,880	3,383	0.58 %	515,987	4,887	0.95 %	506,054	3,512	0.69 %
Noninterest-bearing liabilities									
Demand deposits	236,061			186,615			185,024		
Other liabilities	2,182			1,880			1,446		
Total liabilities	820,123			704,482			692,524		
Shareholders' equity	81,093			72,451			61,933		
Total liabilities and shareholders' equity	\$ 901,216			\$ 776,933			\$ 754,457		
Net interest income		\$ 29,666			\$ 28,217			\$ 27,833	
Interest rate spread			3.32 %			3.60 %			3.74 %
Cost of funds			0.41 %			0.70 %			0.51 %

Interest expense as a percent of average earning assets	0.40 %	0.67 %	0.50 %
Net interest margin	3.50 %	3.88 %	3.93 %

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 21%. The tax-equivalent adjustment was \$198 thousand for 2020, and \$207 thousand for 2019 and 2018.
- (2) Loans placed on a non-accrual status are reflected in the balances.

[Table of Contents](#)

	Volume and Rate					
	Years Ending December 31,					
	2020			2019		
	Volume Effect	Rate Effect	Change in Income/Expense	Volume Effect	Rate Effect	Change in Income/Expense
Interest-bearing deposits in other banks	\$ (522)	\$ 209	\$ (313)	\$ (143)	\$ 107	\$ (36)
Loans, taxable	2,288	(1,726)	562	1,733	365	2,098
Loans, tax-exempt	(29)	—	(29)	(21)	3	(18)
Securities, taxable	63	(320)	(257)	(236)	(83)	(319)
Securities, tax-exempt	11	(25)	(14)	32	(10)	22
Securities, restricted	7	(11)	(4)	9	3	12
Federal funds sold	—	—	—	—	—	—
Total earning assets	\$ 1,818	\$ (1,873)	\$ (55)	\$ 1,374	\$ 385	\$ 1,759
Checking	\$ 331	\$ (1,022)	\$ (691)	\$ 27	\$ 279	\$ 306
Money market accounts	733	(1,437)	(704)	239	469	708
Savings accounts	1	(4)	(3)	(22)	—	(22)
Certificates of deposits:						
Less than \$100	(46)	20	(26)	(34)	120	86
Greater than \$100	(19)	(67)	(86)	30	236	266
Brokered deposits	(1)	(4)	(5)	1	4	5
Federal funds purchased	(1)	—	(1)	1	—	1
Subordinated debt	167	(26)	141	—	—	—
Junior subordinated debt	—	(127)	(127)	—	23	23
Other borrowings	(1)	(1)	(2)	2	—	2
Total interest-bearing liabilities	\$ 1,164	\$ (2,668)	\$ (1,504)	\$ 244	\$ 1,131	\$ 1,375
Change in net interest income	\$ 654	\$ 795	\$ 1,449	\$ 1,130	\$ (746)	\$ 384

Provision for Loan Losses

The provision for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio.

The Bank recorded a provision for loan losses of \$3.0 million for 2020, which resulted in a total allowance for loan losses of \$7.5 million, or 1.19% of total loans, at December 31, 2020. This compared to a provision for loan losses of \$450 thousand for 2019, which resulted in an allowance for loan losses of \$4.9 million, or 0.86% of total loans, at the prior year end.

The provision for loan losses for the year ended December 31, 2020 resulted from net charge-offs on loans and increases in both the general and specific reserve components of the allowance for loan losses. Net charge-offs totaled \$449 thousand for the year ended December 31, 2020, compared to \$525 thousand of net charge-offs for the same period of 2019. The general reserve component of the allowance for loan losses increased primarily from adjustments to qualitative factors, which resulted from the Bank's observation of unfavorable changes in economic indicators impacted by the pandemic, consideration of risks associated with loans modified for interest-only payments in accordance with the CARES Act, and an increase in substandard loan amounts. The increase in the specific reserve component of the allowance for loan losses included reserves placed on newly identified impaired loans during the year.

For the year ended December 31, 2019, the provision for loan losses resulted from net charge-offs on loans and an increase in the general reserve component of the allowance for loan losses that were partially offset by a decrease in the specific reserve component. The general reserve increased during the period, primarily from the impact of loan growth during the year and changes in qualitative adjustments. The specific reserve decreased from improvements in collateral positions on impaired loans, principal payments received, and the resolution of certain impaired loans.

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 does not believe that net charge-offs experienced in 2021 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 in "Asset Quality" below.

COVID-19 Pandemic Impact on Provision for Loan Losses

The Bank may experience higher provision for loan losses in future periods from factors including higher specific reserves on newly identified impaired loans, higher levels of net charge-offs, and additional adjustments to qualitative factors in the general reserve component of the allowance for loan losses. The Bank believes the length of time and extent that the Bank's customers experience business interruptions from the pandemic will impact the amount of provision for loan losses in future periods.

[Table of Contents](#)

Noninterest Income

Noninterest income decreased \$327 thousand, or 4%, to \$8.2 million for the year ended December 31, 2020, compared to \$8.6 million for the same period in 2019. The decrease in noninterest income was primarily attributable to an \$898 thousand, or 31%, decrease in service charges on deposit accounts from lower deposit overdraft fees. This decrease was partially offset by a \$340 thousand, or 18%, increase in wealth management fees and a \$297 thousand, or 43%, increase in fees for other customer services. Wealth management fees increased primarily from higher balances of assets under management during the year ended December 31, 2020 compared to the same period one year ago. Assets under management increased as a result of new business relationships and from growth in the market values of existing accounts. The increase in fees for other customer services was primarily a result of fee income from brokered residential mortgage loans.

COVID-19 Pandemic Impact on Noninterest Income

The number of customer overdrafts and resulting income from service charges on deposits decreased significantly during 2020. The Bank believes this may have resulted from a reduction in consumer spending due to government stay at home orders, social distancing and an increase in unemployment. The lower amount of overdrafts may have also been impacted by receipt of government stimulus checks and an increase in the average balances of customer deposit accounts. The Bank also suspended certain overdraft fees at the beginning of the second quarter in an effort to provide relief to its customers who may have experienced financial difficulties related to the pandemic. The suspension of the overdraft fees ended on September 30, 2020. Service charges on deposits may continue to remain at recent levels, or decrease, depending on factors that include customer spending behaviors and the balance of deposit accounts.

ATM and check card fee revenue may also be lower in future periods as customers may spend and visit ATM machines less during periods of uncertainty. Wealth management revenue may decrease in future periods if the market values of investments decline and mortgage fee income may decrease if the number of home purchases and refinancing activity slows in the Bank's market area.

Noninterest Expense

Noninterest expense decreased \$532 thousand, or 2%, to \$23.8 million for the year ended December 31, 2020, compared to \$24.3 million for the same period in 2019. The decrease in noninterest expense was primarily attributable to a \$246 thousand, or 2%, decrease in salaries and employee benefits, a \$296 thousand, or 45%, decrease in marketing expense, and a \$431 thousand, or 15%, decrease in other operating expense. The decrease in salaries and employee benefits resulted primarily from the deferral of \$535 thousand of salary costs to originate PPP loans during the second and third quarters of 2020. Marketing expense decreased from a combination of reduced spending on marketing campaigns during the year and elevated expenses during 2019 from the timing of marketing initiatives. Other operating expense decreased primarily from lower dues and subscription costs, education and training costs, registration and licensing fees, travel costs, debit card losses, employee recruiting fees, and loan servicing costs for purchased loans. These decreases were partially offset by a \$202 thousand increase in FDIC assessment from the use of small bank assessment credits during 2019.

The \$535 thousand of deferred salary costs described above were netted against \$2.5 million of loan fee income, and are being accreted into earnings evenly over the life of the loans through interest and fees on loans. Approximately 99% of the PPP loans originated in 2020 will mature in the second quarter of 2022 and approximately 1% of the loans will mature in the quarter of 2025. If loans are paid off or forgiven prior to maturity dates, the remaining balance of net deferred loan fees would be recognized during the same period.

COVID-19 Pandemic Impact on Noninterest Expense

If asset quality deteriorates as a result of the pandemic, the Bank may incur an increase in expenses related to the resolution of problem loans including appraisal costs, legal and professional fees, OREO expenses and losses on the sale of OREO. The Bank believes the length of time and extent that the Bank's customers experience business interruptions from the pandemic will impact the amount of noninterest expense in future periods.

Income Taxes

Income tax expense decreased by \$189 thousand for the year ended December 31, 2020, compared to the same period of 2019. The Company's income tax expense 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, 2020 and 2019. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income and income from bank owned life insurance. For a more detailed discussion of the Company's income tax expense, see Note 11 to the Consolidated Financial Statements included in this Form 10-K.

[Table of Contents](#)

Financial Condition

General

Total assets increased \$150.9 million to \$950.9 million at December 31, 2020, compared to \$800.0 million at December 31, 2019. The increase was primarily attributable to a \$53.0 million increase in net loans, a \$15.9 million increase in securities, and a \$78.0 million increase in interest-bearing deposits in banks. The increase in net loans included \$64.7 million of PPP loans at December 31, 2020.

At December 31, 2020, total liabilities increased \$143.2 million to \$866.0 million compared to \$722.8 million at December 31, 2019. The increase was primarily attributable to a \$136.0 million increase in total deposits. Proceeds from PPP loan originations and the receipt of government stimulus checks by customers during the year contributed to the increase in deposits. Noninterest-bearing demand deposits and savings and interest-bearing deposits increased \$73.6 million and \$79.8 million, respectively, while time deposits decreased \$17.4 million. Subordinated debt also increased during 2020 as the Company issued a 5.50% fixed-to-floating rate subordinated note with a principal amount of \$5.0 million to an institutional investor.

Total shareholders' equity increased \$7.7 million to \$84.9 million at December 31, 2020, compared to \$77.2 million at December 31, 2019. The increase was primarily attributable to a \$6.7 million increase in retained earnings and a \$2.7 million increase in accumulated other comprehensive income. These increases were partially offset by a \$1.7 million decrease in common stock and surplus, which resulted primarily from stock repurchases in the first quarter of 2020 under the Company's stock repurchase plan. Tangible common equity totaled \$84.9 million at December 31, 2020, an increase of 10% compared to \$77.0 million at December 31, 2019. The Company's capital ratios continued to exceed the minimum capital requirements for regulatory purposes.

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 areas. As a provider of community-oriented financial services, the Bank does not attempt to further geographically diversify its loan portfolio by undertaking significant lending activity outside its market areas.

Loans, net of allowance for loan losses, increased \$53.0 million to \$622.4 million at December 31, 2020, compared to \$569.4 million at December 31, 2019. Commercial and industrial loans increased by \$59.7 million during 2020, followed by commercial real estate loans and residential real estate loans that increased by \$10.3 million and \$6.4 million, respectively. These increases were partially offset by construction loans, consumer loans, and other loans that decreased by \$15.8 million, \$4.2 million, and \$812 thousand, respectively. The increase in commercial and industrial loans included \$64.7 million of PPP loans at December 31, 2020.

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

		Loan Portfolio														
		At December 31,														
		2020			2019			2018			2017			2016		
Commercial, financial, and agricultural		\$ 109,838		17.44 %	\$ 50,153		8.73 %	\$ 44,605		8.22 %	\$ 38,763		7.42 %	\$ 29,981		6.17
Real estate - construction		27,328		4.34 %	43,164		7.51 %	45,867		8.45 %	35,927		6.88 %	34,699		7.14
Real estate - mortgage:																
Residential (1-4 family)		235,814		37.43 %	229,438		39.95 %	215,945		39.78 %	208,177		39.87 %	198,763		40.89
Other real estate loans		246,883		39.19 %	236,555		41.19 %	219,553		40.44 %	222,256		42.56 %	211,210		43.45
Consumer		6,601		1.05 %	10,774		1.88 %	12,336		2.27 %	12,333		2.36 %	4,875		1.00
All other loans		3,450		0.55 %	4,262		0.74 %	4,550		0.84 %	4,745		0.91 %	6,539		1.35
Total loans		\$ 629,914		100 %	\$ 574,346		100 %	\$ 542,856		100 %	\$ 522,201		100 %	\$ 486,067		100
Less: allowance for loan losses		7,485			4,934			5,009			5,326			5,321		
Loans, net of allowance for loan losses		\$ 622,429			\$ 569,412			\$ 537,847			\$ 516,875			\$ 480,746		

There was no category of loans that exceeded 10% of outstanding loans at December 31, 2020 that were not disclosed in the above table.

[Table of Contents](#)

The following table sets forth the maturities of the loan portfolio at December 31, 2020 (in thousands):

Remaining Maturities of Selected Loans				
At December 31, 2020				
	Less than One Year	One to Five Years	Greater than Five Years	Total
Commercial, financial, and agricultural	\$ 14,947	\$ 88,336	\$ 6,555	\$ 109,838
Real estate construction and land development	12,884	6,582	7,862	27,328
Real estate - mortgage:				
Residential (1-4 family)	7,318	13,579	214,917	235,814
Other real estate loans	13,160	28,320	205,403	246,883
Consumer	790	5,686	125	6,601
All other loans	14	3,436	—	3,450
Total loans	\$ 49,113	\$ 145,939	\$ 434,862	\$ 629,914
For maturities over one year:				
Fixed rates	\$ 341,629			
Variable rates	239,172			
	\$ 580,801			

Asset Quality

Management classifies non-performing assets as non-accrual loans and 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 operations or 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 did not have any assets classified as OREO at December 31, 2020 or December 31, 2019.

Non-performing assets totaled \$6.7 million and \$1.5 million at December 31, 2020 and 2019, representing 0.71% and 0.18% of total assets, respectively. Non-performing assets consisted only of non-accrual loans at December 31, 2020 and December 31, 2019.

At December 31, 2020, 66% of non-performing assets were commercial real estate loans, 23% were commercial and industrial loans, 7% were residential real estate loans, and 4% were construction and land development 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 \$1.4 million and \$3.4 million at December 31, 2020 and December 31, 2019, respectively. The amount of other potential problem loans in future periods may be dependent on economic conditions and other factors influencing a customers' ability to meet their debt requirements.

[Table of Contents](#)

Loans greater than 90 days past due and still accruing totaled \$302 thousand at December 31, 2020, which was comprised of two loans expected to pay all principal and interest amounts contractually due to the Bank and one purchased consumer loan. Consumer loans purchased at origination are charged-off when they are greater than 120 days past due. There were \$97 thousand of loans greater than 90 days past due and still accruing at December 31, 2019.

The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's 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 \$7.5 million at December 31, 2020 and \$4.9 million at December 31, 2019, representing 1.19% and 0.86% of total loans, respectively. After analyzing the composition of the loan portfolio, related credit risks, and changes in asset quality 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, 2020. For further discussion regarding the allowance for loan losses, see "Provision for Loan Losses" above.

Recoveries of loan losses of \$160 thousand and \$9 thousand were recorded in the construction and land development and consumer and other loan classes, respectively, during the year ended December 31, 2020. The recovery of loan losses in the construction and land development loan class resulted primarily from a decrease in the general reserve. The decrease in the general reserve for the construction and land development loan class resulted primarily from the impact of a decrease in loans. The recovery of loan losses in the consumer and other loan class resulted from a decrease in the general reserve, which was partially offset by net charge offs on loans. The decrease in the general reserve for the consumer and other loan class resulted from the impact of a decrease in loans and improvements in the historical loss rate. These recoveries were offset by provision for loan losses totaling \$3.2 million in the 1-4 family residential, other real estate, and commercial and industrial loan classes. For more detailed information regarding the provision for loan losses, see Note 4 to the Consolidated Financial Statements included in this Form 10-K.

Impaired loans totaled \$6.7 million and \$1.5 million at December 31, 2020 and 2019, respectively. The related allowance for loan losses required for these loans totaled \$2.2 million and \$33 thousand at December 31, 2020 and December 31, 2019, respectively. The average recorded investment in impaired loans during 2020 and 2019 was \$3.9 million and \$1.9 million, respectively. Included in the impaired loans total are loans classified as TDRs totaling \$6.0 million and \$360 thousand at December 31, 2020 and 2019, respectively. 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, 2020, none of these TDRs were performing under the restructured terms and all were considered non-performing assets.

[Table of Contents](#)

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 loan losses charged to 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 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, changes in accounting standards, 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,									
		2020		2019		2018		2017		2016	
Balance, beginning of period		\$	4,934	\$	5,009	\$	5,326	\$	5,321	\$	5,524
Loans charged-off:											
Commercial, financial and agricultural			69		2		10		—		—
Real estate-construction and land development			—		2		—		—		—
Real estate-mortgage											
Residential (1-4 family)			—		58		55		126		83
Other real estate loans			—		27		—		—		165
Consumer			715		795		1,104		607		540
All other loans			—		—		—		—		—
Total loans charged off		\$	784	\$	884	\$	1,169	\$	733	\$	788
Recoveries:											
Commercial, financial and agricultural		\$	18	\$	8	\$	8	\$	10	\$	11
Real estate-construction and land development			2		50		—		11		4
Real estate-mortgage											
Residential (1-4 family)			8		9		13		302		293
Other real estate loans			2		1		5		50		2
Consumer			305		291		225		263		275
All other loans			—		—		1		2		—
Total recoveries		\$	335	\$	359	\$	252	\$	638	\$	585
Net charge-offs		\$	449	\$	525	\$	917	\$	95	\$	203
Provision for loan losses			3,000		450		600		100		—
Balance, end of period		\$	7,485	\$	4,934	\$	5,009	\$	5,326	\$	5,321
Ratio of net charge-offs during the period to average loans outstanding during the period			0.07 %		0.09 %		0.17 %		0.02 %		0.04 %

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,									
		2020		2019		2018		2017		2016	
Commercial, financial and agricultural		\$	784		562	\$	464		418	\$	380
			17.44 %		8.73 %		8.22 %		7.42 %		6.17 %
Real estate-construction and land development			306		464		561		414		441
			4.34 %		7.51 %		8.45 %		6.88 %		7.14 %

[Table of Contents](#)

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,					
	2020	2019	2018	2017	2016
Non-accrual loans	\$ 6,714	\$ 1,459	\$ 3,172	\$ 937	\$ 1,520
Other real estate owned	—	—	—	326	250
Total non-performing assets	\$ 6,714	\$ 1,459	\$ 3,172	\$ 1,263	\$ 1,770
Loans past due 90 days accruing interest	302	97	235	183	116
Total non-performing assets and past due loans	\$ 7,016	\$ 1,556	\$ 3,407	\$ 1,446	\$ 1,886
Troubled debt restructurings	\$ 5,976	\$ 360	\$ 467	\$ 333	\$ 460
Allowance for loan losses to period end loans	1.19 %	0.86 %	0.92 %	1.02 %	1.09 %
Non-performing assets to period end loans	1.07 %	0.25 %	0.58 %	0.24 %	0.36 %

COVID-19 Pandemic Impact on Asset Quality

The Bank anticipates the pandemic to have an unfavorable impact on the financial condition of many of its customers, and as a result, identified the related credit risk within its loan portfolio throughout 2020 with the goal of mitigating the risk and minimizing potential loan charge-offs. Management expects significant pressure on several sectors of the loan portfolio may continue, including those listed in the following table (dollars in thousands).

Industry	December 31, 2020	
	Loan Balance	Percent of Total Loans
Retail / shopping	\$ 29,080	4.62 %
Lodging	25,189	4.00 %
Leisure	10,368	1.65 %
Total	\$ 64,637	10.27 %

The Bank's asset quality was negatively impacted by higher levels of nonaccrual loans in 2020 compared to 2019. The magnitude of the potential decline in the Bank's asset quality will likely depend on the severity and length of time and extent that the Bank's customers experience business interruptions from the pandemic. The Bank modified loan agreements during the fourth quarter of 2020 for certain business customers to provide payment relief for periods that ranged between 6 and 24 months. These loans were not considered TDRs because they were modified in accordance with relief provisions of the CARES Act. The extent of asset quality deterioration that could result from these modified loans will be impacted by the continuation of customers' business interruptions beyond the modification periods.

Securities

Securities at December 31, 2020 totaled \$156.3 million, an increase of \$15.9 million, or 11%, from \$140.4 million at the end of 2019. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate debt securities, and restricted securities. As of December 31, 2020, 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 \$4.0 million and \$1.3 million at December 31, 2020 and 2019, respectively. Gross unrealized losses in the available for sale portfolio totaled \$82 thousand and \$339 thousand at December 31, 2020 and 2019, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$509 thousand and \$99 thousand at December 31, 2020 and 2019, respectively. There were no gross unrealized losses in the held to maturity portfolio at December 31, 2020. Gross unrealized losses in the held to maturity portfolio totaled \$80 thousand at December 31, 2019. Investments in an unrealized loss position were considered temporarily impaired at December 31, 2020 and 2019. The change in the unrealized gains and losses of investment securities from December 31, 2019 to December 31, 2020 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,			
	2020	2019	2018
Securities available for sale, at fair value:			
U.S. agency and mortgage-backed securities	\$ 101,598	\$ 94,905	\$ 84,922
Obligations of state and political subdivisions	38,627	26,078	14,935
	\$ 140,225	\$ 120,983	\$ 99,857
Securities held to maturity, at amortized cost			
U.S. agency and mortgage-backed securities	\$ 9,588	\$ 12,528	\$ 27,420
Obligations of state and political subdivisions	3,146	3,599	14,488
Corporate debt securities	1,500	1,500	1,500
	\$ 14,234	\$ 17,627	\$ 43,408
Restricted securities, at cost			
Federal Home Loan Bank stock	\$ 818	\$ 776	\$ 763
Federal Reserve Bank stock	980	980	875
Community Bankers' Bank stock	77	50	50
	\$ 1,875	\$ 1,806	\$ 1,688
Total securities	\$ 156,334	\$ 140,416	\$ 144,953

[Table of Contents](#)

The following table shows the maturities of debt and restricted securities at amortized cost and market value at December 31, 2020 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 21% 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 this Form 10-K.

Securities Portfolio Maturity Distribution/Yield Analysis

At December 31, 2020

	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	\$ —	\$ 12,354	\$ 24,261	\$ 71,821	\$ 108,436
Market value	\$ —	\$ 12,860	\$ 25,091	\$ 73,499	\$ 111,450
Weighted average yield	— %	2.50 %	2.20 %	1.74 %	1.93 %
Obligations of state and political subdivisions					
Amortized cost	\$ 593	\$ 5,797	\$ 16,509	\$ 17,754	\$ 40,653
Market value	\$ 596	\$ 5,980	\$ 17,076	\$ 18,261	\$ 41,913
Weighted average yield	2.99 %	2.62 %	2.53 %	2.58 %	2.57 %
Corporate debt securities					
Amortized cost	\$ —	\$ 1,500	\$ —	\$ —	\$ 1,500
Market value	\$ —	\$ 1,605	\$ —	\$ —	\$ 1,605
Weighted average yield	— %	6.77 %	— %	— %	6.77 %
Restricted securities					
Amortized cost	\$ —	\$ —	\$ —	\$ 1,875	\$ 1,875
Market value	\$ —	\$ —	\$ —	\$ 1,875	\$ 1,875
Weighted average yield	— %	— %	— %	5.36 %	5.36 %
Total portfolio					
Amortized cost	\$ 593	\$ 19,651	\$ 40,770	\$ 91,450	\$ 152,464
Market value	\$ 596	\$ 20,445	\$ 42,167	\$ 93,635	\$ 156,843
Weighted average yield (1)	2.99 %	2.86 %	2.33 %	1.97 %	2.19 %

(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, 2020, 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.

[Table of Contents](#)

Deposits

At December 31, 2020, deposits totaled \$842.5 million, an increase of \$136.0 million, from \$706.4 million at December 31, 2019. There was a change in the deposit mix when comparing the periods. At December 31, 2020, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 31%, 57%, and 12% of total deposits, respectively, compared to 27%, 56%, and 17% at December 31, 2019.

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,						
	2020		2019		2018	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing deposits	\$ 236,061	— %	\$ 186,615	— %	\$ 185,024	— %
Interest-bearing deposits:						
Interest checking	\$ 193,870	0.36 %	\$ 163,408	0.85 %	\$ 159,290	0.67 %
Money market	149,029	0.47 %	113,180	1.24 %	87,693	0.79 %
Savings	111,693	0.06 %	106,934	0.07 %	122,497	0.07 %
Time deposits:						
Less than \$100	59,726	0.76 %	66,066	0.73 %	73,262	0.54 %
Greater than \$100	50,176	1.35 %	51,432	1.48 %	48,679	1.02 %
Brokered deposits	579	0.26 %	643	0.91 %	389	0.33 %
Total interest-bearing deposits	\$ 565,073	0.46 %	\$ 501,663	0.82 %	\$ 491,810	0.56 %
Total deposits	\$ 801,134		\$ 688,278		\$ 676,834	

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, 2020	\$ 12,939	\$ 4,821	\$ 10,321	\$ 14,218	\$ 42,299

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, 2020, cash, interest-bearing and noninterest-bearing deposits with banks, securities, and loans maturing within one year totaled \$177.0 million. At December 31, 2020, 8% or \$49.1 million of the loan portfolio matured within one year. Non-deposit sources of available funds totaled \$237.7 million at December 31, 2020, which included \$160.3 million of secured funds available from Federal Home Loan Bank of Atlanta (FHLB), \$51.0 million of unsecured federal funds lines of credit with other correspondent banks, and \$26.4 million available through the Federal Reserve Discount Window.

On February 18, 2021, the Company entered into an agreement to acquire Fincastle for an aggregate purchase price of approximately \$31.6 million of cash and stock. Cash consideration will total 20% and remaining 80% of the consideration will be from the issuance of Company common stock. The Company estimates that it will incur aggregate pre-tax merger related costs of approximately \$4.2 million during 2021.

COVID-19 Pandemic Impact on Liquidity

Although the Bank's liquidity has not been negatively impacted by the pandemic during 2020, it could be reduced in future periods. Factors that could reduce the Bank's liquidity include a reduction in cash inflows from loan customers if they would experience financial difficulties and are not able to make contractual payments. Other factors that could reduce liquidity include decreasing customer deposit balances, increasing customer draws on their lines of credit with the Bank, and a reduction in the available lines of credit from correspondent banks. The Bank actively manages and monitors liquidity risk in order to maintain sufficient liquidity to meet the demand from its customers.

Subordinated Debt

See Note 9 to the Consolidated Financial Statements included in this Form 10-K, for discussion of subordinated debt.

Junior Subordinated Debt

See Note 10 to the Consolidated Financial Statements included in this Form 10-K, for discussion of junior subordinated debt.

[Table of Contents](#)

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, 2020 and 2019, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2020	2019
Commitments to extend credit and unfunded commitments under lines of credit	\$ 114,892	\$ 92,528
Stand-by letters of credit	10,675	10,950

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 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, 2020, the Bank had \$10.4 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.

On April 21, 2020, the Company entered into interest rate swap agreements related to its outstanding junior subordinated debt. The Company uses derivatives to manage exposure to interest rate risk through the use of interest rate swaps. Interest rate swaps involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional principal amount and maturity date with no exchange of underlying principal amounts.

The interest rate swaps qualified and are designated as cash flow hedges. The Company's cash flow hedges effectively modify the Company's exposure to interest rate risk by converting variable rates of interest on \$9.0 million of the Company's junior subordinated debt to fixed rates of interest for periods that end between June 2034 and October 2036. The cash flow hedges' total notional amount is \$9.0 million. At December 31, 2020, the cash flow hedges had a fair value of \$431 thousand, which is recorded in other assets. The net gain/loss on the cash flow hedges is recognized as a component of other comprehensive income and reclassified into earnings in the same period(s) during which the hedged transactions affect earnings. The Company's derivative financial instruments are described more fully in Note 24 to the Consolidated Financial Statements included in this Form 10-K.

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.

Effective January 1, 2015, the Bank became subject to capital rules adopted by federal bank regulators implementing the Basel III regulatory capital reforms adopted by the Basel Committee on Banking Supervision (the Basel Committee), and certain changes required by the Dodd-Frank Act.

The minimum capital level requirements applicable to the Bank under the final rules are as follows: a new common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6%; a total capital ratio of 8%; 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 was phased-in over four years and, as fully implemented effective January 1, 2019, requires a buffer of 2.5% of risk-weighted assets. This results in the following minimum capital 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 of December 31, 2020 and December 31, 2019, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

[Table of Contents](#)

The following table summarizes the Bank's regulatory capital and related ratios at December 31, 2020, 2019, and 2018 (dollars in thousands).

Analysis of Capital			
At December 31,			
	2020	2019	2018
Common equity Tier 1 capital	\$ 84,032	\$ 80,505	\$ 69,688
Tier 1 capital	84,032	80,505	69,688
Tier 2 capital	7,211	4,934	5,009
Total risk-based capital	91,243	85,439	74,697
Risk-weighted assets	576,612	575,569	548,236
Capital ratios:			
Common equity Tier 1 capital ratio	14.57 %	13.99 %	12.71 %
Tier 1 capital ratio	14.57 %	13.99 %	12.71 %
Total capital ratio	15.82 %	14.84 %	13.62 %
Leverage ratio (Tier 1 capital to average assets)	8.80 %	10.13 %	9.26 %
Capital conservation buffer ratio(1)	7.82 %	6.84 %	5.62 %

- (1) Calculated by subtracting the regulatory minimum capital ratio requirements from the Company's actual ratio for 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 prompt corrective action framework 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 required to meet the following capital level requirements in order to qualify as "well capitalized:" a common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8%; a total capital ratio of 10%; and a Tier 1 leverage ratio of 5%. The Bank met the requirements to qualify as "well capitalized" as of December 31, 2020 and 2019.

On September 17, 2019 the FDIC finalized a rule that introduces an optional simplified measure of capital adequacy for qualifying community banking organizations (i.e., the community bank leverage ratio (CBLR) framework), as required by the Economic Growth Act. The CBLR framework is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.

In order to qualify for the CBLR framework, a community banking organization must have a tier 1 leverage ratio greater than 9%, less than \$10 billion in total consolidated assets, and limited amounts of off-balance sheet exposures and trading assets and liabilities. The CARES Act temporarily lowered the tier 1 leverage ratio requirement to 8% until December 31, 2020. A qualifying community banking organization that opts into the CBLR framework and meets all requirements under the framework will be considered to have met the "well-capitalized" ratio requirements under the prompt corrective action regulations and will not be required to report or calculate risk-based capital. Although the Bank did not opt into the CBLR framework at December 31, 2020, it may opt into the CBLR framework in a future quarterly period. For further discussion regarding the CARES Act, see "Supervision and Regulation" included in Item 1 of this Form 10-K.

During the fourth quarter of 2019, the Board of Directors of the Company authorized a stock repurchase plan pursuant to which the Company may have repurchased up to \$5.0 million of its outstanding common stock. The stock repurchase plan was authorized to run through December 31, 2020, unless the entire amount authorized to be repurchased had been acquired before that date. As of December 31, 2020, the Company had repurchased and retired 129,035 shares at an average price paid per share of \$16.05, for a total of \$2.1 million. The Company did not repurchase any shares of its common stock during 2019.

The Company's capital resources may be affected by the Company's acquisition of Fincastle, which is expected to be completed in the third quarter of 2021. Fincastle shareholders are expected to receive aggregate merger consideration of \$6.7 million in cash and approximately 1.3 million shares of the Company's common stock. First Bank is not expected to pay a significant dividend to the Company prior to the completion of the merger to fund the cash portion of the purchase price and the Company's merger related expenses. Although First Bank's capital is not expected to be impacted by a significant dividend, the acquisition of Fincastle is expected to generate goodwill and other intangible assets that will be excluded from the regulatory capital of First Bank, which may result in a decrease in First Bank's regulatory capital ratios. Additionally, the Company expects to incur aggregate pre-tax merger related expenses of approximately \$4.2 million during 2021. For the year ended December 31, 2020, the Company did not incur any merger related expenses. First Bank expects that it will remain well-capitalized following the completion of the Company's acquisition of Fincastle.

COVID-19 Pandemic Impact on Capital Resources

The Company will continue to update its enterprise risk assessment and capital plan as the operating environment develops. As a result of its risk assessments and capital planning, the Company issued \$5.0 million of subordinated debt in June 2020, primarily to further strengthen holding company liquidity and remain a source of strength for the Bank in the event of a severe economic downturn. The Company may also use the proceeds of the issuance for general corporate purposes, including the potential repayment of the Company's existing subordinated debt, which became callable on a quarterly basis beginning in January 2021. The Company's stock repurchase plan remained suspended during the second, third and fourth quarters of 2020 and ended on December 31, 2020. The Company has not authorized another stock repurchase plan due to the potential impact of the pandemic on the economy and the Bank's customers. The capital planning process also included consideration of whether to continue the Company's cash dividend payments to common shareholders during 2020. The Company declared and paid an \$0.11 per share during each quarter of 2020.

Recent Accounting Pronouncements

See Note 1 to the Consolidated Financial Statements included in this Form 10-K, for discussion of recent accounting pronouncements.

[Table of Contents](#)

Quarterly Results

The table below lists the Company's quarterly performance for the years ended December 31, 2020 and 2019 (in thousands, except per share data).

	2020				
	Fourth	Third	Second	First	Total
Interest and dividend income	\$ 8,095	\$ 8,343	\$ 8,245	\$ 8,168	\$ 32,851
Interest expense	638	769	834	1,142	3,383
Net interest income	7,457	7,574	7,411	7,026	29,468
Provision for (recovery of) loan losses	(200)	1,500	800	900	3,000
Net interest income after provision for (recovery of) loan losses	7,657	6,074	6,611	6,126	26,468
Noninterest income	2,152	2,201	1,773	2,099	8,225
Noninterest expense	5,894	6,135	5,613	6,144	23,786
Income before income taxes	3,915	2,140	2,771	2,081	10,907
Income tax expense	759	386	528	376	2,049
Net income	\$ 3,156	\$ 1,754	\$ 2,243	\$ 1,705	\$ 8,858
Net income per share, basic	\$ 0.65	\$ 0.36	\$ 0.46	\$ 0.34	\$ 1.82
Net income per share, diluted	\$ 0.65	\$ 0.36	\$ 0.46	\$ 0.34	\$ 1.82

	2019				
	Fourth	Third	Second	First	Total
Interest and dividend income	\$ 8,306	\$ 8,354	\$ 8,214	\$ 8,023	\$ 32,897
Interest expense	1,231	1,283	1,249	1,124	4,887
Net interest income	7,075	7,071	6,965	6,899	28,010
Provision for loan losses	250	—	200	—	450
Net interest income after provision for loan losses	6,825	7,071	6,765	6,899	27,560
Noninterest income	2,341	2,191	2,035	1,985	8,552
Noninterest expense	5,804	6,186	6,230	6,098	24,318
Income before income taxes	3,362	3,076	2,570	2,786	11,794
Income tax expense	646	583	484	525	2,238
Net income	\$ 2,716	\$ 2,493	\$ 2,086	\$ 2,261	\$ 9,556
Net income per share, basic	\$ 0.55	\$ 0.50	\$ 0.42	\$ 0.46	\$ 1.92
Net income per share, diluted	\$ 0.55	\$ 0.50	\$ 0.42	\$ 0.46	\$ 1.92

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.

To the Shareholders
First National Corporation
Strasburg, Virginia

March 31, 2021

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, 2020. 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, 2020. 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, 2020. 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 2020 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.

/s/ Scott C. Harvard

Scott C. Harvard
President
Chief Executive Officer

/s/ M. Shane Bell

M. Shane Bell
Executive Vice President
Chief Financial Officer



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors
First National Corporation
Strasburg, Virginia

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of First National Corporation and subsidiary (the Company) as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting 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.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

[Table of Contents](#)

Allowance for Loan Losses – Loans Collectively Evaluated for Impairment – Qualitative Factors

Description of the Matter

As described in Note 1 (Nature of Banking Activities and Significant Accounting Policies) and Note 4 (Allowance for Loan Losses) to the consolidated financial statements, the Company establishes an allowance for loan losses that represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. The Company's allowance for loan losses consists of specific and general components. The general component covers loans that are not considered impaired and is based on historical loss experience adjusted for qualitative factors. At December 31, 2020, the general component represented \$5,262,000 of the total allowance for loan losses of \$7,485,000. The qualitative factors are assigned by management by loan type based on delinquencies and asset quality, national and local economic trends, effects of changes in the value of underlying collateral, trends in the volume and nature of loans, effects of changes in lending policy, experience and depth of management, concentrations of credit, quality of the loan review system, and effect of external factors such as competition and regulatory requirements. Qualitative factors can change from period to period based on management's assessment and the relative weights given to each factor.

Management exercised significant judgment when assessing the qualitative factors in estimating the allowance for loan losses. We identified the assessment of the qualitative factors as a critical audit matter as auditing the qualitative factors involved especially complex and subjective auditor judgment in evaluating management's assessment of the inherently subjective estimates.

How We Addressed the Matter in Our Audit

The primary audit procedures we performed to address this critical audit matter included:

- Obtain an understanding of controls over the evaluation of qualitative factors, including management's development and review of the data inputs used as the basis for the allocation factors and management's review and approval of the reasonableness of the assumptions used to develop the qualitative adjustments.
- Substantively testing management's process, including evaluating their judgments and assumptions for developing the qualitative factors, which included:
 - Evaluating the completeness and accuracy of data inputs used as a basis for the qualitative factors.
 - Evaluating the reasonableness of management's judgments related to the determination of qualitative factors.
 - Evaluating the qualitative factors for directional consistency and for reasonableness.
 - Testing the mathematical accuracy of the allowance calculation, including the application of the qualitative factors.

/s/ YOUNT, HYDE & BARBOUR, P.C.

We have served as the Company's auditor since 1988.

Winchester, Virginia

March 31, 2021

[Table of Contents](#)
FIRST NATIONAL CORPORATION
Consolidated Balance Sheets

December 31, 2020 and 2019

(in thousands, except share and per share data)

	2020	2019
Assets		
Cash and due from banks	\$ 13,115	\$ 9,675
Interest-bearing deposits in banks	114,182	36,110
Securities available for sale, at fair value	140,225	120,983
Securities held to maturity, at amortized cost (fair value, 2020, \$14,743; 2019, \$17,646)	14,234	17,627
Restricted securities, at cost	1,875	1,806
Loans held for sale	245	167
Loans, net of allowance for loan losses, 2020, \$7,485, 2019, \$4,934	622,429	569,412
Premises and equipment, net	19,319	19,747
Accrued interest receivable	2,717	2,065
Bank owned life insurance	17,916	17,447
Core deposit intangibles, net	19	170
Other assets	4,656	4,839
Total assets	<u>\$ 950,932</u>	<u>\$ 800,048</u>
Liabilities & Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 263,229	\$ 189,623
Savings and interest-bearing demand deposits	479,035	399,255
Time deposits	100,197	117,564
Total deposits	<u>\$ 842,461</u>	<u>\$ 706,442</u>
Subordinated debt	9,991	4,983
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	4,285	2,125
Total liabilities	<u>\$ 866,016</u>	<u>\$ 722,829</u>
Commitments and contingencies		
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, 2020, 4,860,399 shares, 2019, 4,969,716 shares	6,075	6,212
Surplus	6,151	7,700
Retained earnings	69,292	62,583
Accumulated other comprehensive income, net	3,398	724
Total shareholders' equity	<u>\$ 84,916</u>	<u>\$ 77,219</u>
Total liabilities and shareholders' equity	<u>\$ 950,932</u>	<u>\$ 800,048</u>

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION
Consolidated Statements of Income
Years Ended December 31, 2020 and 2019
(in thousands, except per share data)

	2020	2019
Interest and Dividend Income		
Interest and fees on loans	\$ 29,497	\$ 28,958
Interest on deposits in banks	190	503
Interest and dividends on securities:		
Taxable interest	2,448	2,705
Tax-exempt interest	617	628
Dividends	99	103
Total interest and dividend income	\$ 32,851	\$ 32,897
Interest Expense		
Interest on deposits	\$ 2,589	\$ 4,104
Interest on federal funds purchased	—	1
Interest on subordinated debt	501	360
Interest on junior subordinated debt	293	420
Interest on other borrowings	—	2
Total interest expense	\$ 3,383	\$ 4,887
Net interest income	\$ 29,468	\$ 28,010
Provision for loan losses	3,000	450
Net interest income after provision for loan losses	\$ 26,468	\$ 27,560
Noninterest Income		
Service charges on deposit accounts	\$ 2,028	\$ 2,926
ATM and check card fees	2,314	2,330
Wealth management fees	2,208	1,868
Fees for other customer services	983	686
Income from bank owned life insurance	469	456
Net gains on securities available for sale	40	1
Net gains on sale of loans	70	170
Other operating income	113	115
Total noninterest income	\$ 8,225	\$ 8,552

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION

Consolidated Statements of Income

(Continued)

Years Ended December 31, 2020 and 2019

(in thousands, except per share data)

	2020	2019
Noninterest Expense		
Salaries and employee benefits	\$ 13,321	\$ 13,567
Occupancy	1,666	1,652
Equipment	1,707	1,645
Marketing	355	651
Supplies	394	338
Legal and professional fees	1,152	1,086
ATM and check card expenses	980	897
FDIC assessment	247	45
Bank franchise tax	637	538
Data processing expense	759	705
Amortization expense	151	302
Other real estate owned expense, net	—	1
Net (gains) losses on disposal of premises and equipment	(29)	14
Other operating expense	2,446	2,877
Total noninterest expense	\$ 23,786	\$ 24,318
Income before income taxes	\$ 10,907	\$ 11,794
Income tax expense	2,049	2,238
Net income	\$ 8,858	\$ 9,556
Earnings per common share		
Basic	\$ 1.82	\$ 1.92
Diluted	\$ 1.82	\$ 1.92

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2020 and 2019
(in thousands)

	2020	2019
Net income	\$ 8,858	\$ 9,556
Other comprehensive income, net of tax:		
Unrealized holding gains on available for sale securities, net of tax \$629 and \$764, respectively	2,366	2,873
Unrealized holding losses on securities transferred from held to maturity to available for sale, net of tax \$0 and (\$91), respectively	—	(340)
Reclassification adjustment for gains included in net income, net of tax (\$8) and \$0, respectively	(32)	(1)
Change in fair value of cash flow hedges, net of tax \$91 and \$0, respectively	340	—
Total other comprehensive income	2,674	2,532
Total comprehensive income	\$ 11,532	\$ 12,088

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
Years Ended December 31, 2020 and 2019
(in thousands)

	2020	2019
Cash Flows from Operating Activities		
Net income	\$ 8,858	\$ 9,556
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	1,316	1,335
Amortization of core deposit intangibles	151	302
Amortization of debt issuance costs	18	18
Origination of loans held for sale	(4,152)	(12,765)
Proceeds from sale of loans held for sale	4,144	13,187
Net gains on sales of loans held for sale	(70)	(170)
Provision for loan losses	3,000	450
Net gains on securities available for sale	(40)	(1)
Increase in cash value of bank owned life insurance	(469)	(456)
Accretion of discounts and amortization of premiums on securities, net	687	592
Accretion of premium on time deposits	(23)	(60)
Stock-based compensation	290	183
Excess tax benefits on stock-based compensation	(2)	(2)
(Gains) losses on disposal of premises and equipment	(29)	14
Deferred income tax benefit	(923)	(8)
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(652)	48
Decrease (increase) in other assets	828	(820)
Increase in accrued expenses and other liabilities	2,159	448
Net cash provided by operating activities	\$ 15,091	\$ 11,851
Cash Flows from Investing Activities		
Proceeds from maturities, calls, principal payments, and sales of securities available for sale	\$ 34,057	\$ 22,031
Proceeds from maturities, calls, and principal payments of securities held to maturity	3,283	2,240
Purchases of securities available for sale	(50,881)	(17,002)
Net purchase of restricted securities	(69)	(118)
Purchase of premises and equipment, net	(909)	(1,030)
Proceeds from sale of premises and equipment	50	—
Purchase of bank owned life insurance	—	(3,000)
Net increase in loans	(56,017)	(32,015)
Net cash used in investing activities	\$ (70,486)	\$ (28,894)

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
(Continued)
Years Ended December 31, 2020 and 2019
(in thousands)

	2020	2019
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$ 153,386	\$ 37,531
Net decrease in time deposits	(17,344)	(1,595)
Proceeds from subordinated debt, net of issuance costs	4,990	—
Cash dividends paid on common stock, net of reinvestment	(2,007)	(1,674)
Repurchase of common stock, stock incentive plan	(47)	(20)
Repurchase of common stock, employee stock ownership plan	—	(32)
Repurchase of common stock, stock repurchase plan	(2,071)	—
Net cash provided by financing activities	\$ 136,907	\$ 34,210
Increase in cash and cash equivalents	\$ 81,512	\$ 17,167
Cash and Cash Equivalents		
Beginning	45,785	28,618
Ending	\$ 127,297	\$ 45,785
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 3,457	\$ 4,903
Income taxes	\$ 3,088	\$ 2,178
Supplemental Disclosures of Noncash Transactions		
Unrealized gains on securities available for sale	\$ 2,955	\$ 3,636
Unrealized losses on securities transferred from held to maturity to available for sale	\$ —	\$ (431)
Fair value of securities transferred from held to maturity to available for sale	\$ —	\$ 23,036
Change in fair value of cash flow hedges	\$ 431	\$ —
Issuance of common stock, dividend reinvestment plan	\$ 142	\$ 113

See Notes to Consolidated Financial Statements

[Table of Contents](#)

FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2020 and 2019
(in thousands, except share and per share data)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2018	\$ 6,197	\$ 7,471	\$ 54,814	\$ (1,808)	\$ 66,674
Net income	—	—	9,556	—	9,556
Other comprehensive income	—	—	—	2,532	2,532
Cash dividends on common stock (\$0.36 per share)	—	—	(1,787)	—	(1,787)
Stock-based compensation	—	183	—	—	183
Issuance of 5,671 shares common stock, dividend reinvestment plan	7	106	—	—	113
Issuance of 8,902 shares common stock, stock incentive plan	12	(12)	—	—	—
Repurchase of 1,006 shares of common stock, stock incentive plan	(2)	(18)	—	—	(20)
Repurchase of 1,545 shares of common stock, employee stock ownership plan	(2)	(30)	—	—	(32)
Balance, December 31, 2019	<u>\$ 6,212</u>	<u>\$ 7,700</u>	<u>\$ 62,583</u>	<u>\$ 724</u>	<u>\$ 77,219</u>

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2019	\$ 6,212	\$ 7,700	\$ 62,583	\$ 724	\$ 77,219
Net income	—	—	8,858	—	8,858
Other comprehensive income	—	—	—	2,674	2,674
Cash dividends on common stock (\$0.44 per share)	—	—	(2,149)	—	(2,149)
Stock-based compensation	—	290	—	—	290
Issuance of 9,449 shares common stock, dividend reinvestment plan	11	131	—	—	142
Issuance of 12,492 shares common stock, stock incentive plan	16	(16)	—	—	—
Repurchase of 2,223 shares of common stock, stock incentive plan	(3)	(44)	—	—	(47)
Repurchase of 129,035 shares of common stock, stock repurchase plan	(161)	(1,910)	—	—	(2,071)
Balance, December 31, 2020	<u>\$ 6,075</u>	<u>\$ 6,151</u>	<u>\$ 69,292</u>	<u>\$ 3,398</u>	<u>\$ 84,916</u>

See Notes to Consolidated Financial Statements

[Table of Contents](#)

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 and, together with Trust II, the Trusts). 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 Shen-Valley Land Holdings, LLC which was formed to hold other real estate owned and future office sites. The Bank offers loan, deposit, and wealth management products and services in the Shenandoah Valley, central regions of Virginia, and the city of Richmond. Loan products and services include consumer loans, residential mortgages, home equity loans, and commercial loans. Deposit products and services include checking accounts, treasury management solutions, savings accounts, money market accounts, certificates of deposit, and individual retirement accounts. Wealth management services include estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. 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.

Risks and Uncertainties

The outbreak of COVID-19 has adversely impacted a broad range of industries in which the Company's customers operate and could impair their ability to fulfill their financial obligations to the Company. The World Health Organization has declared COVID-19 to be a global pandemic indicating that almost all public commerce and related business activities must be, to varying degrees, curtailed with the goal of decreasing the rate of new infections. The spread of the outbreak has caused disruptions in the U.S. economy and has disrupted banking and other financial activity in the areas in which the Company operates. While there has been no material impact to the Company's employees to date, COVID-19 could also potentially create widespread business continuity issues for the Company.

Congress, the President, and the Federal Reserve have taken several actions designed to cushion the economic fallout. Most notably, the Coronavirus Aid, Relief and Economic Security (CARES) Act was signed into law in March 2020 as a \$2 trillion legislative package and the American Rescue Plan Act of 2021 was signed into law in March 2021 and provides an additional \$1.9 trillion in spending to address the continued impact of COVID-19. The goal of these legislative measures is to prevent a severe economic downturn through various measures, including direct financial aid to American families and economic stimulus to significantly impacted industry sectors. The package also includes extensive emergency funding for hospitals and providers. In addition to the general impact of COVID-19, certain provisions of the CARES Act as well as other recent legislative and regulatory relief efforts may have a material impact on the Company's operations.

The Company's business is dependent upon the willingness and ability of its employees and customers to conduct banking and other financial transactions. If the global response to contain COVID-19 escalates further or is unsuccessful, the Company could experience a material adverse effect on its business, financial condition, results of operations and cash flows. While it is not possible to know the full universe or extent that the impact of COVID-19, and resulting measures to curtail its spread, will have on the Company's operations, the Company is disclosing potentially material items of which it is aware.

Results of Operations

The Company's net interest income could decrease due to COVID-19. In keeping with guidance from regulators, the Company worked with certain COVID-19 affected borrowers to reduce their loan payments by modifying the loan agreements to allow for interest only payments. The loan modification periods ranged from 6 months to 24 months and were intended to provide payment relief to borrowers over the period of time that COVID-19 is expected to continue to negatively affect the profitability of the borrowers' businesses. Although the modified loan payments have been made as agreed and interest income has been recognized by the Company, should the borrowers be negatively affected by COVID-19 for a period of time that extend beyond the loan modification periods, it's possible the borrowers may not be able to resume regular principal and interest payments in future periods and the Company may no longer be able to accrue interest income on the loans. At this time, the Company is unable to project the materiality of such an impact but recognizes the breadth of the economic impact may affect its borrowers' ability to repay in future periods.

The Company's net interest income could also decrease due to adverse economic conditions that may result from COVID-19 and a related decrease in loan demand, causing a shift in earning asset balances from loans into lower

yielding interest-bearing deposits in banks and securities. The decrease in loan demand could also increase the competition for loans and result in a reduction of loan rates offered by other financial institutions.

The Company's noninterest income could decrease due to COVID-19. Service charges on deposits and ATM and check card income decreased during 2020 and may continue to decrease in future periods from less customer spending and or higher balances of customer deposits. Wealth management revenue may decrease in future periods if the market values of investments decline and mortgage fee income may decrease from less home buying activity in the Company's market area. At this time, the Company is unable to project the materiality of such an impact but recognizes it may unfavorably affect its noninterest income in future periods.

Table of Contents

The Company's noninterest expense could increase due to COVID-19. If the Bank's asset quality worsens, it may incur additional loan expenses in future periods from obtaining updated appraisals on loan collateral, additional legal and professional expenses related to the resolution of problem loans, an increase in other real estate owned expense, and potential losses on the sale of other real estate owned.

At this time, the Company is unable to project the full extent or materiality of the foregoing impacts but recognizes the breadth of the economic impacts of COVID-19 may have an unfavorable impact on net interest income, noninterest income, noninterest expense, and loan customers' ability to repay loans, in future periods.

Capital and Liquidity

While the Company believes it has sufficient capital to withstand an extended economic recession brought about by COVID-19, its reported and regulatory capital ratios could be adversely impacted by provision for loan losses in future periods. Larger amounts of provision for loan losses may result from factors including higher specific reserves on newly identified and existing impaired loans, higher levels of net charge-offs, and additional adjustments to qualitative factors in the general reserve component of the Bank's allowance for loan losses. In March 2020, the Company suspended future stock repurchases under its stock repurchase program due to the economic uncertainty caused by the pandemic, and the program remained suspended for the remainder of 2020. In June 2020, the Company issued \$5.0 million of subordinated debt to strengthen holding company liquidity and to remain a source of strength to the Bank in the event of a severe economic downturn resulting from the pandemic. The Company will continue to update its enterprise risk assessment and capital plans as the operating environment develops.

The Company maintains access to multiple sources of liquidity. While wholesale funding markets have remained open, interest rates for short term funding could become volatile. If funding costs would become elevated for an extended period of time, it may have an adverse effect on the Company's net interest margin. If an extended recession causes large numbers of the Company's deposit customers to withdraw their funds, the Company could become more reliant on volatile or more expensive sources of funding.

Processes, Controls and Business Continuity Plan

The Company continues to operate under its Pandemic Continuity of Operations Plan that includes a remote working strategy. The Company has not incurred additional material costs related to employees working remotely. No material operational or internal control challenges or risks have been identified to date. The Company does not anticipate significant challenges to its ability to maintain its systems and controls in light of the measures the Company has taken to prevent the spread of COVID-19. The Company does not currently face any material resource constraint through the implementation of its business continuity plan.

Lending Operations and Accommodations to Borrowers

In keeping with regulatory guidance to work with borrowers during this unprecedented situation, the Company offered a payment deferral program, primarily during the second and third quarters of 2020, for its individual and business customers adversely affected by the pandemic that deferred loan payments for up to 90 days. As of December 31, 2020, there were \$1.2 million of loans that remained in the program and 99% of the loans that participated in the program returned to current payment status. In accordance with the CARES Act and interagency guidance issued in August 2020, these short-term loan payment deferrals were not considered troubled debt restructurings.

During the fourth quarter of 2020, the Bank modified terms of certain loans for customers that continued to be negatively impacted by the pandemic. The loan modifications lowered borrower loan payments by allowing interest only payments for periods ranging between 6 and 24 months. All loans modified were in the Bank's commercial real estate loan portfolio and totaled \$14.3 million at December 31, 2020. The loans were comprised of \$12.8 million in the lodging sector and \$1.5 million in the leisure sector.

With the passage of the Paycheck Protection Program (PPP), administered by the Small Business Administration (SBA), the Company actively participated in assisting its customers with applications for resources through the program. During the second and third quarters of 2020, the Bank originated \$76.6 million of PPP loans, received \$2.5 million of loan fees, and incurred \$535 thousand of loan origination costs. The loan fees are being accreted into earnings evenly over the life of the loans, net of the loan costs, through interest and fees on loans. Approximately 99% of the PPP loan balances will mature in the second quarter of 2022 and 1% of the loan balances will mature in the third quarter of 2025. The Company believes the majority of these loans will ultimately be forgiven and repaid by the SBA in accordance with the terms of the program. As of December 31, 2020, PPP loan balances totaled \$64.7 million and customers with PPP loan balances totaling \$2.0 million had requested debt forgiveness and had not yet been notified by the SBA of their forgiveness decision. It is the Company's understanding that loans funded through the PPP program are fully guaranteed by the U.S. government. Should those circumstances change, the Company could be required to establish additional allowance for loan losses through additional provision for loan losses charged to earnings.

Congress revived the PPP (new PPP) as part of the COVID-19 relief bill that was signed into law on December 27, 2020. The Bank began participating as a lender in the new PPP in January of 2021. As of February 28, 2021, the

Bank originated \$18.9 million of new PPP loans. Loan fees received on new PPP loans will also be accreted into earnings evenly over the life of the loans, net of the loan costs, through interest and fees on loans. These new PPP loans will mature in the first quarter of 2026.

[Table of Contents](#)

Asset Quality

The economic impact of the pandemic had an unfavorable impact on the financial condition of certain Bank customers. The Bank entered into loan modification agreements in the fourth quarter of 2020 to provide relief to certain customers that were continuing to experience temporary business interruptions from the pandemic. The modifications were designed to help borrowers continue their business operations while minimizing potential loan charge-offs. The Bank expects significant pressure on several sectors of the loan portfolio to continue, including retail shopping, and lodging and leisure, among others.

The magnitude of the potential decline in the Bank's loan quality will likely depend on the length and extent that the Bank's customers experience business interruptions from the pandemic.

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.

Significant Group Concentrations of Credit Risk

Most of the Company's activities are with customers located within the Shenandoah Valley, central regions of Virginia, and the city of Richmond. 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, and HTM securities are carried at amortized cost. When an individual AFS security is sold, the Company releases the income tax effects associated with the AFS security from accumulated other comprehensive income. 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.

[Table of Contents](#)

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.

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 commercial buildings, 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.

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, office and retail buildings, industrial and warehouse buildings, hotels, and religious facilities.

[Table of Contents](#)

Commercial and Industrial Loans: Commercial loans may be unsecured or secured with non-real estate commercial property. The Company's banking subsidiary makes commercial loans to businesses located within its market area and also to businesses outside of its market area through loan participations with other financial institutions. Loans originated under the SBA's PPP are also included in this loan class.

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. The Company's banking subsidiary makes consumer loans to individuals located within its market area and also to individuals outside of its market through the purchase of loans from another financial institution.

A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate throughout the Bank's market area. 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.

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 \$6.0 million and \$360 thousand in loans classified as TDRs as of December 31, 2020 and 2019, respectively.

[Table of Contents](#)

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management 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 the Company's 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, 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.

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 typically 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.

[Table of Contents](#)

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 operations or 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, if any, and adjusts the values as appropriate. Revenue and expenses from operations and changes in the valuation allowance are included in other real estate owned 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 also recorded as income from bank owned life insurance. The Company is exposed to credit risk to the extent an insurance company is unable to fulfill its financial obligations under a policy.

[Table of Contents](#)

Intangible Assets

Intangible assets consist of a core deposit intangible asset arising from a branch acquisition which is amortized on an accelerated method over its estimated useful life of six years.

Derivative Financial Instruments

On April 21, 2020, the Company entered into two interest rate swap agreements related to its outstanding junior subordinated debt. The Company recognizes derivative financial instruments at fair value as either an other asset or other liability in its Consolidated Balance Sheets. The Company's derivative financial instruments are comprised of interest rate swaps that qualify and are designated as cash flow hedges on the Company's junior subordinated debt. Gains or losses on the Company's cash flow hedges are reported as a component of other comprehensive income, net of deferred income taxes, and reclassified into earnings in the same period(s) during which the hedged transactions affect earnings. The Company's derivative financial instruments are described more fully in Note 24.

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

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

Deferred income tax assets and liabilities are determined using the asset and liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Deferred taxes are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

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, 2020 and 2019. Interest and penalties associated with unrecognized tax benefits, if any, are classified as additional income taxes in the consolidated statements of income.

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.

[Table of Contents](#)

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. Potential common shares that may be issued by the Company relate to restricted stock units and are determined using the treasury method. See Note 14 for further information regarding earnings per common share.

Advertising Costs

The Company follows the policy of charging the production costs of advertising to expense as incurred. Total advertising expense incurred for 2020 and 2019 was \$208 thousand and \$449 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 changes in fair values of cash flow hedges, 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.

Business Combination

On February 18, 2021, the Company entered into an agreement to acquire The Bank of Fincastle (Fincastle) for an aggregate purchase price of \$31.6 million of cash and stock. Additional information about the acquisition is presented in Note 25.

Adoption of New Accounting Standards

In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-04, "Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment" (ASU 2017-04). ASU 2017-04 simplifies the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in the previous two-step impairment test. Under the new guidance, if a reporting unit's carrying amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates the prior requirement to calculate a goodwill impairment charge using Step 2, which requires an entity to calculate any impairment charge by comparing the implied fair value of goodwill with its carrying amount. ASU 2017-04 was effective for the Company on January 1, 2020. The adoption of this standard did not have a material effect on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820) - Changes to the Disclosure Requirements for Fair Value Measurement" (ASU 2018-13). ASU 2018-13 modifies the disclosure requirements on fair value measurements by requiring that Level 3 fair value disclosures include the range and weighted average of significant unobservable inputs used to develop those fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements. Certain disclosure requirements in Topic 820 were also removed or modified. ASU 2018-13 was effective for the Company on January 1, 2020. The adoption of this standard did not have a material effect on the Company's consolidated financial statements.

In March 2020 (revised in April 2020), various regulatory agencies, including the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, (the agencies) issued an interagency statement on loan modifications and reporting for financial institutions working with customers affected by COVID-19. The interagency statement was effective immediately and impacted accounting for loan modifications. Under Accounting Standards Codification 310-40, "Receivables – Troubled Debt Restructurings by Creditors,"

(ASC 310-40), a restructuring of debt constitutes a TDR if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The agencies confirmed with the staff of the FASB that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not to be considered TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented. In August 2020, a joint statement on additional loan modifications was issued. Among other things, the Interagency Statement addresses accounting and regulatory reporting considerations for loan modifications, including those accounted for under Section 4013 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The CARES Act was signed into law on March 27, 2020 to help support individuals and businesses through loans, grants, tax changes and other types of relief. The most significant impacts of the CARES Act related to accounting for loan modifications and establishment of the Paycheck Protection Program (PPP). On December 21, 2020, the Consolidated Appropriates Act of 2021 (CAA) was passed. The CAA extends or modifies many of the relief programs first created by the CARES Act, including the PPP and treatment of certain loan modifications related to the COVID-19 pandemic. This interagency guidance is expected to have a material impact on the Company's financial statements; however, this impact cannot be quantified at this time. For further information about the Company's loan modifications in response to COVID-19 to borrowers who were current prior to any relief, see Note 4.

[Table of Contents](#)

Recent Accounting Pronouncements

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” (ASU 2016-13). 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 FASB has issued multiple updates to ASU 2016-13 as codified in Topic 326, including ASU’s 2019-04, 2019-05, 2019-10, 2019-11, 2020-02, and 2020-03. These ASU’s have provided for various minor technical corrections and improvements to the codification as well as other transition matters. Smaller reporting companies who file with the U.S. Securities and Exchange Commission (SEC) and all other entities who do not file with the SEC are required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. 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, which has analyzed gathered data, defined loan pools and segments, and selected methods for applying the concepts included in this ASU. The Company is in the process of testing selected models, building policy and processing documentation, modeling the impact of the ASU on the capital and strategic plans, performing model validation, and finalizing policies and procedures. This guidance may result in material changes in the Company's accounting for credit losses of financial instruments.

Effective November 25, 2019, the SEC adopted Staff Accounting Bulletin (SAB) 119. SAB 119 updated portions of SEC interpretative guidance to align with FASB ASC 326, “Financial Instruments – Credit Losses.” It covers topics including (1) measuring current expected credit losses; (2) development, governance, and documentation of a systematic methodology; (3) documenting the results of a systematic methodology; and (4) validating a systematic methodology.

In December 2019, the FASB issued ASU No. 2019-12, “Income Taxes (Topic 740) – Simplifying the Accounting for Income Taxes” (ASU 2019-12). The ASU is expected to reduce cost and complexity related to the accounting for income taxes by removing specific exceptions to general principles in Topic 740 (eliminating the need for an organization to analyze whether certain exceptions apply in a given period) and improving financial statement preparers’ application of certain income tax-related guidance. This ASU is part of the FASB’s simplification initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2019-12 to have a material impact on its consolidated financial statements.

In January 2020, the FASB issued ASU No. 2020-01, “Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815” (ASU 2020-01). The ASU is based on a consensus of the Emerging Issues Task Force and is expected to increase comparability in accounting for these transactions. ASU 2016-01 made targeted improvements to accounting for financial instruments, including providing an entity the ability to measure certain equity securities without a readily determinable fair value at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Among other topics, the amendments clarify that an entity should consider observable transactions that require it to either apply or discontinue the equity method of accounting. For public business entities, the amendments in the ASU are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2020-01 to have a material impact on its consolidated financial statements.

In March 2020, the FASB issued ASU No. 2020-04, “Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting” (ASU 2020-04). These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference LIBOR or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. Subsequently, in January 2021, the FASB issued ASU No. 2021-01 “Reference Rate Reform (Topic 848): Scope” (ASU 2021-01). This ASU clarifies that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. The ASU also amends the expedients and exceptions in Topic 848 to capture the incremental consequences of the scope clarification and to tailor the existing guidance to derivative instruments affected by the discounting transition. An entity may elect to apply ASU 2021-01 on contract modifications that change the interest rate used for margining, discounting, or contract price alignment retrospectively as of any date from the beginning of the interim period that includes March 12, 2020, or prospectively to new modifications from any date within the interim period that includes or is subsequent to January 7, 2021, up to the date that financial statements are available to be issued. An entity may elect to apply ASU 2021-01 to eligible hedging relationships existing as of the beginning of the interim period that includes March 12, 2020, and to new eligible hedging relationships entered into after the beginning of

the interim period that includes March 12, 2020. The Company is currently in the process of identifying loans and other financial instruments that are directly or indirectly influenced by LIBOR. The Company is assessing ASU 2020-04 and its impact on the Company's transition away from LIBOR for its loan and other financial instruments.

[Table of Contents](#)

On March 12, 2020, the SEC finalized amendments to its “accelerated filer” and “large accelerated filer” definitions. The amendments increase the threshold criteria for meeting these filer classifications and were effective on April 27, 2020. Any changes in filer status are to be applied beginning with the filer’s first annual report filed with the SEC subsequent to the effective date. Prior to these changes, the Company was required to comply with section 404(b) of the Sarbanes Oxley Act concerning auditor attestation over internal control over financial reporting as an “accelerated filer” as it had more than \$75 million in public float but less than \$700 million at the end of the Company’s most recent second quarter. The rule change revises the definition of “accelerated filers” to exclude entities with public float of less than \$700 million and less than \$100 million in annual revenues. The Company did not meet this revised category of accelerated filer as of June 30, 2020, and will no longer be considered as such. If the Company’s annual revenues exceed \$100 million, its category will change back to “accelerated filer”. The classifications of “accelerated filer” and “large accelerated filer” require a public company to obtain an auditor attestation concerning the effectiveness of internal control over financial reporting (ICFR) and include the opinion on ICFR in its annual report on Form 10-K. Non-accelerated filers, such as the Company, also have additional time to file quarterly and annual financial statements. All public companies are required to obtain and file annual financial statement audits, as well as provide management’s assertion on effectiveness of internal control over financial reporting, but the external auditor attestation of internal control over financial reporting is not required for non-accelerated filers. These amendments changed the Company’s reporting and audit requirements as it has the additional time provided to file quarterly and annual financial statements and is no longer required to obtain an auditor attestation concerning the internal controls over financial reporting.

In August 2020, the FASB issued ASU No. 2020-06, "Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity’s Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity" (ASU 2020-06). The ASU simplifies accounting for convertible instruments by removing major separation models required under current U.S. GAAP. Consequently, more convertible debt instruments will be reported as a single liability instrument and more convertible preferred stock as a single equity instrument with no separate accounting for embedded conversion features. The ASU removes certain settlement conditions that are required for equity contracts to qualify for the derivative scope exception, which will permit more equity contracts to qualify for it. The ASU also simplifies the diluted earnings per share (EPS) calculation in certain areas. In addition, the amendment updates the disclosure requirements for convertible instruments to increase the information transparency. For public business entities, excluding smaller reporting companies, the amendments in the ASU are effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other entities, the standard will be effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2020-06 to have a material impact on its consolidated financial statements.

In October 2020, the FASB issued ASU No. 2020-08, "Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable fees and Other Costs" (ASU 2020-08). This ASU clarifies that an entity should reevaluate whether a callable debt security is within the scope of ASC paragraph 310-20-35-33 for each reporting period. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is not permitted. All entities should apply ASU 2020-08 on a prospective basis as of the beginning of the period of adoption for existing or newly purchased callable debt securities. The Company does not expect the adoption of ASU 2020-08 to have a material impact on its consolidated financial statements.

Note 2. Securities

	2020			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$ 98,848	\$ 2,830	\$ (80)	\$ 101,598
Obligations of states and political subdivisions	37,507	1,122	(2)	38,627
Total securities available for sale	<u>\$ 136,355</u>	<u>\$ 3,952</u>	<u>\$ (82)</u>	<u>\$ 140,225</u>
Securities held to maturity:				
U.S. agency and mortgage-backed securities	\$ 9,588	\$ 264	\$ —	\$ 9,852
Obligations of states and political subdivisions	3,146	140	—	3,286
Corporate debt securities	1,500	105	—	1,605
Total securities held to maturity	<u>\$ 14,234</u>	<u>\$ 509</u>	<u>\$ —</u>	<u>\$ 14,743</u>
Total securities	<u>\$ 150,589</u>	<u>\$ 4,461</u>	<u>\$ (82)</u>	<u>\$ 154,968</u>
	2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$ 94,461	\$ 778	\$ (334)	\$ 94,905
Obligations of states and political subdivisions	25,607	476	(5)	26,078
Total securities available for sale	<u>\$ 120,068</u>	<u>\$ 1,254</u>	<u>\$ (339)</u>	<u>\$ 120,983</u>
Securities held to maturity:				
U.S. agency and mortgage-backed securities	\$ 12,528	\$ 6	\$ (80)	\$ 12,454
Obligations of states and political subdivisions	3,599	81	—	3,680
Corporate debt securities	1,500	12	—	1,512
Total securities held to maturity	<u>\$ 17,627</u>	<u>\$ 99</u>	<u>\$ (80)</u>	<u>\$ 17,646</u>
Total securities	<u>\$ 137,695</u>	<u>\$ 1,353</u>	<u>\$ (419)</u>	<u>\$ 138,629</u>

[Table of Contents](#)

At December 31, 2020 and 2019, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

2020						
	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	\$ 17,367	\$ (80)	\$ —	\$ —	\$ 17,367	\$ (80)
Obligations of states and political subdivisions	1,020	(2)	—	—	1,020	(2)
Total securities available for sale	<u>\$ 18,387</u>	<u>\$ (82)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 18,387</u>	<u>\$ (82)</u>
2019						
	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	\$ 29,853	\$ (207)	\$ 13,083	\$ (127)	\$ 42,936	\$ (334)
Obligations of states and political subdivisions	1,373	(5)	—	—	1,373	(5)
Total securities available for sale	<u>\$ 31,226</u>	<u>\$ (212)</u>	<u>\$ 13,083</u>	<u>\$ (127)</u>	<u>\$ 44,309</u>	<u>\$ (339)</u>
Securities held to maturity:						
U.S. agency and mortgage-backed securities	\$ 3,516	\$ (10)	\$ 5,936	\$ (70)	\$ 9,452	\$ (80)
Total securities held to maturity	<u>\$ 3,516</u>	<u>\$ (10)</u>	<u>\$ 5,936</u>	<u>\$ (70)</u>	<u>\$ 9,452</u>	<u>\$ (80)</u>
Total securities	<u>\$ 34,742</u>	<u>\$ (222)</u>	<u>\$ 19,019</u>	<u>\$ (197)</u>	<u>\$ 53,761</u>	<u>\$ (419)</u>

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, 2020, there were seven out of one hundred and one U.S. agency and mortgage-backed securities and one out of eighty-four obligations of states 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 3.5 years at December 31, 2020. At December 31, 2019, there were forty-two out of ninety-four U.S. agency and mortgage-backed securities and three out of seventy-nine 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, 2019. The weighted-average re-pricing term of the portfolio was 3.7 years at December 31, 2019. The unrealized losses at December 31, 2020 in the U.S. agency and mortgage-backed securities portfolio and the obligations of states and political subdivisions portfolio were related to changes in market interest rates and not credit concerns of the issuers.

[Table of Contents](#)

The amortized cost and fair value of securities at December 31, 2020 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	\$ 201	\$ 202	\$ 392	\$ 394
Due after one year through five years	13,608	14,152	6,043	6,293
Due after five years through ten years	38,483	39,790	2,287	2,377
Due after ten years	84,063	86,081	5,512	5,679
	<u>\$ 136,355</u>	<u>\$ 140,225</u>	<u>\$ 14,234</u>	<u>\$ 14,743</u>

Proceeds from maturities, calls, principal payments, and sales of securities available for sale during 2020 and 2019 were \$34.1 million and \$22.0 million, respectively. Gross gains of \$40 thousand and \$1 thousand were realized on calls and sales during 2020 and 2019, respectively. The Company did not realize any gross losses on calls or sales during 2020 or 2019.

Proceeds from maturities, calls, and principal payments of securities held to maturity during 2020 and 2019 were \$3.3 million and \$2.2 million, respectively. There were no sales of securities from the held to maturity portfolio for the years ended December 31, 2020 or 2019. The Company did not realize any gross gains or gross losses on held to maturity securities during 2020 or 2019.

On January 1, 2019, the Company adopted ASU No. 2017-12 and reclassified eligible securities with a fair value of \$23.0 million from the held to maturity portfolio to the available for sale portfolio. The unrealized loss associated with the reclassified securities totaled \$431 thousand on the date of reclassification. The securities were reclassified to provide the Company with opportunities to maximize asset utilization.

Securities having a fair value of \$66.5 million and \$40.5 million at December 31, 2020 and 2019 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, 2020, and no impairment has been recognized.

The composition of restricted securities at December 31, 2020 and 2019 was as follows (in thousands):

	2020	2019
Federal Home Loan Bank stock	\$ 818	\$ 776
Federal Reserve Bank stock	980	980
Community Bankers' Bank stock	77	50
	<u>\$ 1,875</u>	<u>\$ 1,806</u>

The Company also holds limited partnership investments in Small Business Investment Companies (SBICs), which are included in other assets in the Consolidated Balance Sheets. The limited partnership investments are measured as equity investments without readily determinable fair values at their cost, less any impairment. The amounts included in other assets for the limited partnership investments were \$529 thousand and \$514 thousand at December 31, 2020 and 2019, respectively.

[Table of Contents](#)
Note 3. Loans

Loans at December 31, 2020 and 2019 are summarized as follows (in thousands):

	2020	2019
Real estate loans:		
Construction and land development	\$ 27,328	\$ 43,164
Secured by 1-4 family residential	235,814	229,438
Other real estate	246,883	236,555
Commercial and industrial loans	109,838	50,153
Consumer and other loans	10,051	15,036
Total loans	\$ 629,914	\$ 574,346
Allowance for loan losses	(7,485)	(4,934)
Loans, net	\$ 622,429	\$ 569,412

Net deferred loan fees included in the above loan categories were \$1.6 million and \$340 thousand at December 31, 2020 and 2019, respectively. Consumer and other loans included \$143 thousand and \$374 thousand of demand deposit overdrafts at December 31, 2020 and 2019, respectively.

The following tables provide a summary of loan classes and an aging of past due loans as of December 31, 2020 and 2019 (in thousands):

December 31, 2020								
	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	\$ 47	\$ 20	\$ —	\$ 67	\$ 27,261	\$ 27,328	\$ 276	\$ —
1-4 family residential	657	125	324	1,106	234,708	235,814	449	298
Other real estate loans	—	131	133	264	246,619	246,883	4,441	—
Commercial and industrial	104	—	—	104	109,734	109,838	1,548	—
Consumer and other loans	16	21	4	41	10,010	10,051	—	4
Total	\$ 824	\$ 297	\$ 461	\$ 1,582	\$ 628,332	\$ 629,914	\$ 6,714	\$ 302

December 31, 2019								
	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	\$ —	\$ 136	\$ 30	\$ 166	\$ 42,998	\$ 43,164	\$ 367	\$ 30
1-4 family residential	1,428	306	115	1,849	227,589	229,438	630	67

Other real estate loans	457	—	416	873	235,682	236,555	462	—
Commercial and industrial	45	50	—	95	50,058	50,153	—	—
Consumer and other loans	83	79	—	162	14,874	15,036	—	—
Total	<u>\$ 2,013</u>	<u>\$ 571</u>	<u>\$ 561</u>	<u>\$ 3,145</u>	<u>\$ 571,201</u>	<u>\$ 574,346</u>	<u>\$ 1,459</u>	<u>\$ 97</u>

[Table of Contents](#)

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.

The following tables provide an analysis of the credit risk profile of each loan class as of December 31, 2020 and 2019 (in thousands):

December 31, 2020					
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 26,896	\$ —	\$ 432	\$ —	\$ 27,328
Secured by 1-4 family residential	235,035	—	779	—	235,814
Other real estate loans	242,441	—	4,442	—	246,883
Commercial and industrial	107,383	—	2,455	—	109,838
Consumer and other loans	10,051	—	—	—	10,051
Total	<u>\$ 621,806</u>	<u>\$ —</u>	<u>\$ 8,108</u>	<u>\$ —</u>	<u>\$ 629,914</u>

December 31, 2019					
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 42,636	\$ —	\$ 528	\$ —	\$ 43,164
Secured by 1-4 family residential	228,029	524	885	—	229,438
Other real estate loans	233,240	537	2,778	—	236,555
Commercial and industrial	48,527	948	678	—	50,153
Consumer and other loans	10,976	4,060	—	—	15,036
Total	<u>\$ 563,408</u>	<u>\$ 6,069</u>	<u>\$ 4,869</u>	<u>\$ —</u>	<u>\$ 574,346</u>

Note 4. Allowance for Loan Losses

The following tables present, as of December 31, 2020 and 2019, the total allowance for loan losses, the allowance by impairment methodology, and loans by impairment methodology (in thousands).

December 31, 2020						
	Construction and Land Development	Secure by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2019	\$ 464	\$ 776	\$ 2,296	\$ 562	\$ 836	\$ 4,934
Charge-offs	—	—	—	(69)	(715)	(784)
Recoveries	2	8	2	18	305	335
Provision for (recovery of) loan losses	(160)	238	2,658	273	(9)	3,000
Ending Balance, December 31, 2020	\$ 306	\$ 1,022	\$ 4,956	\$ 784	\$ 417	\$ 7,485
Ending Balance:						
Individually evaluated for impairment	—	—	2,065	158	—	2,223
Collectively evaluated for impairment	306	1,022	2,891	626	417	5,262
Loans:						
Ending Balance	27,328	235,814	246,883	109,838	10,051	629,914
Individually evaluated for impairment	276	449	4,441	1,548	—	6,714
Collectively evaluated for impairment	27,052	235,365	242,442	108,290	10,051	623,200

December 31, 2019						
	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, 2018	\$ 561	\$ 895	\$ 2,160	\$ 464	\$ 929	\$ 5,009
Charge-offs	(2)	(58)	(27)	(2)	(795)	(884)
Recoveries	50	9	1	8	291	359
Provision for (recovery of) loan losses	(145)	(70)	162	92	411	450
Ending Balance, December 31, 2019	\$ 464	\$ 776	\$ 2,296	\$ 562	\$ 836	\$ 4,934
Ending Balance:						
Individually evaluated for impairment	22	11	—	—	—	33
Collectively evaluated for impairment	442	765	2,296	562	836	4,901
Loans:						
Ending Balance	43,164	229,438	236,555	50,153	15,036	574,346
Individually evaluated for impairment	367	630	462	—	—	1,459
Collectively evaluated for impairment	42,797	228,808	236,093	50,153	15,036	572,887

[Table of Contents](#)

Impaired loans and the related allowance at December 31, 2020 and 2019, were as follows (in thousands):

December 31, 2020							
	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	\$ 325	\$ 276	\$ —	\$ 276	\$ —	\$ 344	\$ —
Secured by 1-4 family	568	449	—	449	—	517	1
Other real estate loans	4,492	171	4,270	4,441	2,065	2,623	109
Commercial and industrial	1,582	—	1,548	1,548	158	393	77
Total	<u>\$ 6,967</u>	<u>\$ 896</u>	<u>\$ 5,818</u>	<u>\$ 6,714</u>	<u>\$ 2,223</u>	<u>\$ 3,877</u>	<u>\$ 187</u>
December 31, 2019							
	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	\$ 401	\$ 70	\$ 297	\$ 367	\$ 22	\$ 369	\$ 1
Secured by 1-4 family	729	488	142	630	11	769	1
Other real estate loans	509	462	—	462	—	766	3
Commercial and industrial	—	—	—	—	—	22	—
Total	<u>\$ 1,639</u>	<u>\$ 1,020</u>	<u>\$ 439</u>	<u>\$ 1,459</u>	<u>\$ 33</u>	<u>\$ 1,926</u>	<u>\$ 5</u>

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. Only loan classes with balances are included in the tables above.

As of December 31, 2020, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$6.0 million. At December 31, 2020, none of the loans classified as TDRs were performing under the restructured terms and all were considered non-performing assets. There were \$360 thousand in TDRs at December 31, 2019, none 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 were two loans modified as TDRs during the year ended December 31, 2020. A loan secured by commercial real estate was modified as a TDR because the loan was converted to interest only and a commercial and industrial loan was modified as a TDR because interest and principal payments on the loan were deferred for a significant period of time. The TDRs described above increased the specific reserve component of the allowance for loan losses by \$2.2 million at December 31, 2020. There was one loan secured by 1-4 family residential real estate modified as a TDR during the year ended December 31, 2019 because the loan was extended with terms considered to be below market. The loan modified as a TDR during 2019 did not have an impact on the allowance for loan losses at December 31, 2019.

In response to the COVID-19 pandemic, the Company created and implemented a loan payment deferral program for individual and business customers beginning in the first quarter of 2020, which provided them the opportunity to defer monthly payments for 90 days. As of December 31, 2020, loans that remained in the program totaled \$1.2 million. These loans were not considered TDRs because they were modified in accordance with relief provisions of the CARES Act and recent interagency regulatory guidance.

During the fourth quarter of 2020, the Company modified terms of certain loans for customers that continued to be negatively impacted by the COVID-19 pandemic. The loan modifications lowered borrower loan payments by allowing interest only payments for periods ranging between 6 and 24 months. As of December 31, 2020, loans that were modified totaled \$14.3 million. These loans were not considered TDRs because they were modified in accordance with relief provisions of the CARES Act.

For the years ended December 31, 2020 and 2019, there were no TDRs that subsequently defaulted within twelve months of the loan modification. Management defines default as over 90 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, 2020 and December 31, 2019. Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income in the amount of \$271 thousand and \$96 thousand during the years ended December 31, 2020 and 2019, respectively.

Note 5. Other Real Estate Owned

The Bank did not have any OREO activity during the years ended December 31, 2020 and 2019. Accordingly, there were no residential real estate properties included in the ending OREO balances above at December 31, 2020 and 2019. 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, 2020.

The Bank did not have any expenses applicable to OREO for the year ended December 31, 2020. Net expenses applicable to OREO, other than the provision for losses, were \$1 thousand for the year ended December 31, 2019.

Note 6. Premises and Equipment

Premises and equipment are summarized as follows at December 31, 2020 and 2019 (in thousands):

	2020	2019
Land	\$ 4,717	\$ 4,717
Buildings and leasehold improvements	19,816	19,754
Furniture and equipment	7,550	6,815
Construction in process	16	17
	\$ 32,099	\$ 31,303
Less accumulated depreciation	12,780	11,556
	\$ 19,319	\$ 19,747

Depreciation expense included in operating expenses for 2020 and 2019 was \$1.3 million.

Note 7. Deposits

The aggregate amount of time deposits, in denominations of \$250 thousand or more, was \$12.9 million and \$21.4 million at December 31, 2020 and 2019, respectively.

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2020 and 2019, brokered deposits totaled \$596 thousand and \$556 thousand, respectively, and were included in time deposits on the Company's consolidated financial statements.

[Table of Contents](#)

At December 31, 2020, the scheduled maturities of time deposits were as follows (in thousands):

2021	\$	61,570
2022		14,322
2023		9,562
2024		6,899
2025		7,826
Thereafter		18
	\$	<u>100,197</u>

Note 8. Other Borrowings

The Company had an unsecured line of credit totaling \$5.0 million with a non-affiliated bank at December 31, 2020. There were no borrowings outstanding on the line of credit at December 31, 2020. The interest rate on the line of credit floats at Wall Street Journal Prime Rate plus 0.25%, with a floor of 3.50%, and matures on March 25, 2026.

The Bank had unused lines of credit totaling \$237.7 million and \$218.1 million available with non-affiliated banks at December 31, 2020 and 2019, 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 \$160.3 million at December 31, 2020. The Bank had collateral pledged on the borrowing line at December 31, 2020 and 2019 including real estate loans totaling \$221.1 million and \$194.9 million, respectively, and FHLB stock with a book value of \$818 thousand and \$776 thousand, respectively. The Bank did not have borrowings from the FHLB at December 31, 2020 and 2019.

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 bears interest at a fixed rate of 6.75% per annum. Debt issuance costs related to the note were fully amortized at December 31, 2020. Unamortized debt issuance costs related to the note were \$17 thousand at December 31, 2019. 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 January 1, 2021 through maturity, at the Company's option, on any scheduled interest payment date. 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.

On June 29, 2020, the Company issued an interest only subordinated term note due 2030 in the aggregate principal amount of \$5.0 million. The note initially bears interest at a fixed rate of 5.50% per annum. Beginning July 1, 2025, the interest rate shall reset quarterly to an interest rate per annum equal to the current three-month Secured Overnight Financing Rate (SOFR), plus 510 basis points. Unamortized debt issuance costs related to the note were \$9 thousand at December 31, 2020. The note has a maturity date of July 1, 2030. Subject to regulatory approval, the Company may prepay the note, in part or in full, beginning on July 1, 2025 through maturity, at the Company's option, on any scheduled interest payment date. The note 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.

Both of the notes are unsecured, subordinated obligations of the Company and they rank junior in right of payment to the Company's existing and future senior indebtedness and to the Company's obligations to its general creditors. The notes rank equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the notes. The notes rank senior to all current and future junior subordinated debt obligations, preferred stock, and common stock of the Company. The notes are not convertible into common stock or preferred stock, and are not callable by the holders.

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, 2020 and 2019 was 2.83% and 4.50%, 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, 2020 and 2019 was 1.83% and 3.70%, 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.

[Table of Contents](#)

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 2017.

Net deferred tax assets consisted of the following components at December 31, 2020 and 2019 (in thousands):

	2020	2019
Deferred Tax Assets		
Allowance for loan losses	\$ 1,572	\$ 1,036
Post-retirement benefits	101	46
Core deposit intangible	381	391
Unvested stock-based compensation	31	18
Limited partnership investments	8	13
Lease liability	72	67
Loan origination fees, net	328	71
	<u>\$ 2,493</u>	<u>\$ 1,642</u>
Deferred Tax Liabilities		
Depreciation	\$ 663	\$ 741
Right of use asset	73	68
Unrealized gains on securities available for sale	813	192
Cash flow hedges	91	—
	<u>\$ 1,640</u>	<u>\$ 1,001</u>
Net deferred tax assets	<u>\$ 853</u>	<u>\$ 641</u>

The income tax expense for the years ended December 31, 2020 and 2019 consisted of the following (in thousands):

	2020	2019
Current tax expense	\$ 2,972	\$ 2,246
Deferred tax benefit	(923)	(8)
	<u>\$ 2,049</u>	<u>\$ 2,238</u>

[Table of Contents](#)

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, 2020 and 2019, due to the following (in thousands):

	2020	2019
Computed tax expense at statutory federal rate	\$ 2,290	\$ 2,477
Increase in income taxes resulting from:		
Other	10	14
Decrease in income taxes resulting from:		
Tax-exempt interest and dividend income	(153)	(157)
Income from bank owned life insurance	(98)	(96)
	<u>\$ 2,049</u>	<u>\$ 2,238</u>

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, 2020, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company, without prior regulatory approval, totaled \$14.1 million. The amount of unrestricted funds is generally 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.

The Bank is typically required to maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. At December 31, 2020, there was no minimum reserve requirement as a result of a rule adopted by the Federal Reserve in March 2020 eliminating the reserve requirement. For the final weekly reporting period in the year ended December 31, 2019, the aggregate amount of daily average required balances was approximately \$8.3 million.

Note 13. Benefit Plans

401(k) Plan

The Company maintains a 401(k) plan (the 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, 2020 and 2019, expense attributable to the Plan amounted to \$815 thousand and \$812 thousand, respectively.

Supplemental Executive Retirement Plans

On March 15, 2019, the Company entered into supplemental executive retirement plans and participation agreements with three of its employees. The retirement benefits are fixed and provide for retirement benefits payable in 180 monthly installments. The contribution expense totaled \$264 thousand and \$220 thousand for the years ended December 31, 2020 and 2019, respectively, and was solely funded by the Company.

[Table of Contents](#)

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, 2020 and 2019 (dollars in thousands, except per share data):

	2020	2019
(Numerator):		
Net income	\$ 8,858	\$ 9,556
(Denominator):		
Weighted average shares outstanding – basic	4,878,139	4,964,832
Potentially dilutive common shares – restricted stock units	2,127	3,100
Weighted average shares outstanding – diluted	4,880,266	4,967,932
Income per common share		
Basic	\$ 1.82	\$ 1.92
Diluted	\$ 1.82	\$ 1.92

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, 2020 and 2019, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2020	2019
Commitments to extend credit and unfunded commitments under lines of credit	\$ 114,892	\$ 92,528
Stand-by letters of credit	10,675	10,950

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 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, 2020, the Bank had \$10.4 million in locked-rate commitments to originate mortgage loans and \$245 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, 2020 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$41 thousand.

[Table of Contents](#)

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, 2020 and 2019, these loans totaled \$1.3 million and \$299 thousand, respectively. During 2020, total principal additions were \$1.2 million and total principal payments were \$128 thousand.

Deposits from related parties held by the Bank at December 31, 2020 and 2019 amounted to \$6.9 million and \$12.9 million, respectively.

Note 17. Lease Commitments

On January 1, 2019, the Company adopted ASU No. 2016-02, "Leases (Topic 842)" and all subsequent ASUs that modified Topic 842. The Company elected the prospective application approach provided by ASU No. 2018-11 and did not adjust prior periods for ASC 842. There was no cumulative effect adjustment at adoption. The Company also elected certain practical expedients within the standard and did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. Prior to adoption, all of the Company's leases were classified as operating leases and remained operating leases at adoption. The implementation of the new standard resulted in recognition of a right-of-use asset and lease liability of \$390 thousand for leases existing at the date of adoption.

Contracts that commence subsequent to adoption are evaluated to determine whether they are or contain a lease in accordance with Topic 842. The Company has elected the practical expedient provided by Topic 842 not to allocate consideration in a contract between lease and non-lease components. The Company also elected, as provided by the standard, not to recognize right-of-use assets and lease liabilities for short-term leases, defined by the standard as leases with terms of 12 months or less. The Company has not entered into any new operating leases since adoption.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and, if applicable, prepaid rent, initial direct costs, and any incentives received from the lessor.

Lease payments

Lease payments for short-term leases are recognized as lease expense on a straight-line basis over the lease term, or for variable lease payments, in the period in which the obligation was incurred. Payments for leases with terms longer than twelve months are included in the determination of the lease liability. Payments may be fixed for the term of the lease or variable. If the lease agreement provides a known escalator, such as a specified percentage increase per year or a stated increase at a specified time, the variable payment is included in the cash flows used to determine the lease liability. If the variable payment is based upon an unknown escalator, such as the consumer price index at a future date, the increase is not included in the cash flows used to determine the lease liability. Three of the Company's leases provide known escalators that are included in the determination of the lease liability. The remaining leases do not have variable payments during the term of the lease.

Options to extend, residual value guarantees, and restrictions and covenants

Of the Company's six leases, four leases offer the option to extend the lease. The calculation of the lease liability includes the additional time and lease payments for options which the Company is reasonably certain it will exercise. None of the Company's leases provide for residual value guarantees and none provide restrictions or covenants that would impact dividends or require incurring additional financial obligations.

The following table presents the operating lease right-of-use asset and operating lease liability as of December 31, 2020 and 2019 (in thousands):

Classification in the Consolidated Balance Sheet		2020	2019
Operating lease right-of-use asset	Other assets	\$ 347	\$ 325
Operating lease liability	Accrued interest payable and other liabilities	341	321

The following table presents the weighted average remaining operating lease term and the weighted average discount rate for operating leases as of December 31, 2020 and 2019:

	2020	2019
Weighted average remaining lease term, in years	3.2	2.9
Weighted average discount rate	1.72 %	2.60 %

[Table of Contents](#)

The following table presents the components of operating lease expense and supplemental cash flow information for the years ended December 31, 2020 and 2019 (in thousands):

	2020	2019
Lease Expense		
Operating lease expense	\$ 135	\$ 133
Short-term lease expense	2	4
Total lease expense (1)	\$ 137	\$ 137
Cash paid for amounts included in lease liability	\$ 138	\$ 136

(1) Included in occupancy expense in the Company's consolidated statements of income.

The following table presents a maturity schedule of undiscounted cash flows that contribute to the operating lease liability as of December 31, 2020 (in thousands):

Twelve months ending December 31, 2021	\$ 139
Twelve months ending December 31, 2022	115
Twelve months ending December 31, 2023	42
Twelve months ending December 31, 2024	31
Twelve months ending December 31, 2025	21
Total undiscounted cash flows	\$ 348
Less: discount	(7)
Operating lease liability	\$ 341

The contracts in which the Company is lessee are with parties external to the Company and not related parties.

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 Nasdaq Capital Market stock exchange for the 10 business days immediately preceding the dividend payment date.

The Company issued 9,449 and 5,671 common shares to the DRIP during the years ended December 31, 2020 and 2019, 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.

[Table of Contents](#)

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.
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).

Derivative asset/liability - cash flow hedges

Cash flow hedges are recorded at fair value on a recurring basis. The fair value of the Company's cash flow hedges is determined by a third party vendor using the discounted cash flow method (Level 2).

The following tables present the balances of assets measured at fair value on a recurring basis as of December 31, 2020 and 2019 (in thousands).

Description	Balance as of December 31, 2020	Fair Value Measurements at December 31, 2020		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 101,598	\$ —	\$ 101,598	\$ —
Obligations of states and political subdivisions	38,627	—	38,627	—
Total securities available for sale	\$ 140,225	\$ —	\$ 140,225	\$ —

Derivatives - cash flow hedges	431	—	431	—
Total assets	\$ 140,656	\$ —	\$ 140,656	\$ —

[Table of Contents](#)

Description	Balance as of December 31, 2019	Fair Value Measurements at December 31, 2019		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 94,905	\$ —	\$ 94,905	\$ —
Obligations of states and political subdivisions	26,078	—	26,078	—
Total assets	\$ 120,983	\$ —	\$ 120,983	\$ —

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, 2020 and 2019.

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 less estimated costs to sell. 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 loan losses on the Consolidated Statements of Income.

[Table of Contents](#)

The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis as of December 31, 2020 and 2019 (dollars in thousands).

Description	Balance as of December 31, 2020	Fair Value Measurements at December 31, 2020		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 3,595	\$ —	\$ —	\$ 3,595

Description	Balance as of December 31, 2019	Fair Value Measurements at December 31, 2019		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 406	\$ —	\$ —	\$ 406

Quantitative information about Level 3 Fair Value Measurements for December 31, 2020

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (1)
Impaired loans, net	\$ 2,205	Property appraisals	Selling cost	10.00 %
Impaired loans, net	1,390	Present value of cash flows	Discount rate	6.50 %

Quantitative information about Level 3 Fair Value Measurements for December 31, 2019

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (1)
Impaired loans, net	\$ 406	Property appraisals	Selling cost	10.00 %

(1) Unobservable inputs were weighted by the relative fair value of the instruments.

[Table of Contents](#)

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 carrying values and estimated fair values of the Company's financial instruments at December 31, 2020 and 2019 are as follows (in thousands):

Fair Value Measurements at December 31, 2020 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	\$ 127,297	\$ 127,297	\$ —	\$ —	\$ 127,297
Securities available for sale	140,225	—	140,225	—	140,225
Securities held to maturity	14,234	—	13,138	1,605	14,743
Restricted securities	1,875	—	1,875	—	1,875
Loans held for sale	245	—	245	—	245
Loans, net	622,429	—	—	633,638	633,638
Bank owned life insurance	17,916	—	17,916	—	17,916
Accrued interest receivable	2,717	—	2,717	—	2,717
Derivatives - cash flow hedges	431	—	431	—	431
Financial Liabilities					
Deposits	\$ 842,461	\$ —	\$ 742,264	\$ 101,154	\$ 843,418
Subordinated debt	9,991	—	—	10,304	10,304
Junior subordinated debt	9,279	—	—	10,364	10,364
Accrued interest payable	134	—	134	—	134

Fair Value Measurements at December 31, 2019 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	\$ 45,785	\$ 45,785	\$ —	\$ —	\$ 45,785
Securities available for sale	120,983	—	120,983	—	120,983
Securities held to maturity	17,627	—	16,134	1,512	17,646
Restricted securities	1,806	—	1,806	—	1,806
Loans held for sale	167	—	167	—	167
Loans, net	569,412	—	—	572,910	572,910
Bank owned life insurance	17,447	—	17,447	—	17,447
Accrued interest receivable	2,065	—	2,065	—	2,065
Financial Liabilities					
Deposits	\$ 706,442	\$ —	\$ 588,878	\$ 117,071	\$ 705,949
Subordinated debt	4,983	—	—	5,023	5,023
Junior subordinated debt	9,279	—	—	9,724	9,724
Accrued interest payable	184	—	184	—	184

[Table of Contents](#)

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 phased in over a multi-year schedule, and became fully phased in 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 was phased-in over four years, which began on January 1, 2016 and was fully implemented on January 1, 2019.

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, 2020 and December 31, 2019, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2020, 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, 2020 and December 31, 2019 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, 2020:						
Total Capital (to Risk-Weighted Assets)	\$ 91,243	15.82 %	\$ 46,129	8.00 %	\$ 57,661	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)	\$ 84,032	14.57 %	\$ 34,597	6.00 %	\$ 46,129	8.00 %
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 84,032	14.57 %	\$ 25,948	4.50 %	\$ 37,480	6.50 %
Tier 1 Capital (to Average Assets)	\$ 84,032	8.80 %	\$ 38,187	4.00 %	\$ 47,733	5.00 %
December 31, 2019:						
Total Capital (to Risk-Weighted Assets)	\$ 85,439	14.84 %	\$ 46,046	8.00 %	\$ 57,557	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)	\$ 80,505	13.99 %	\$ 34,534	6.00 %	\$ 46,046	8.00 %

Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 80,505	13.99 %	\$ 25,901	4.50 %	\$ 37,412	6.50 %
Tier 1 Capital (to Average Assets)	\$ 80,505	10.13 %	\$ 31,799	4.00 %	\$ 39,749	5.00 %

[Table of Contents](#)

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. Accordingly, the Bank was required to maintain a capital conservation buffer of 2.50% at December 31, 2020 and December 31, 2019, respectively. Under the final rules, an institution is 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, 2020 and December 31, 2019, the capital conservation buffer of the Bank was 7.82% and 6.84%, respectively.

Note 21. Accumulated Other Comprehensive Income (Loss)

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

	Net Unrealized Gains (Losses) on Securities	Change in Fair Value of Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2018	\$ (1,808)	\$ —	\$ (1,808)
Unrealized holding gains (net of tax, \$764)	2,873	—	2,873
Unrealized holding losses transferred from held to maturity to available for sale (net of tax, (\$91))	(340)	—	(340)
Reclassification adjustment (net of tax, \$0)	(1)	—	(1)
Change during period	2,532	—	2,532
Balance at December 31, 2019	\$ 724	\$ —	\$ 724
Unrealized holding gains (net of tax, \$629)	2,366	—	2,366
Reclassification adjustment (net of tax, (\$8))	(32)	—	(32)
Change in fair value (net of tax, \$91)	—	340	340
Change during period	2,334	340	2,674
Balance at December 31, 2020	\$ 3,058	\$ 340	\$ 3,398

The following table presents information related to reclassifications from accumulated other comprehensive income (loss) for the years ended December 31, 2020 and 2019 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss)	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Consolidated Statements of Income
	For the year ended December 31,		
	2020	2019	
Securities available for sale:			
Net securities gains reclassified into earnings	\$ (40)	\$ (1)	Net gains on securities available for sale
Related income tax expense	8	—	Income tax expense
Total reclassifications	\$ (32)	\$ (1)	Net of tax

[Table of Contents](#)

Note 22. 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 2020, the Company granted and issued 3,500 shares of common stock to members of the Board of Directors for their dedicated service and support. Compensation expense related to stock awards totaled \$50 thousand and \$67 thousand for the years ended December 31, 2020 and 2019, 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 2020, 14,457 restricted stock units were granted to employees, with 4,825 units vesting immediately and 9,632 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:

	2020	
	Shares	Weighted Average Grant Date Fair Value
Unvested, January 1, 2020	10,393	\$ 19.26
Granted	14,457	20.94
Vested	(8,992)	19.96
Forfeited	—	—
Unvested, December 31, 2020	15,858	\$ 20.40

At December 31, 2020, 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 \$177 thousand. This expense is expected to be recognized through 2024. Compensation expense related to restricted stock unit awards recognized for the years ended December 31, 2020 and 2019 totaled \$240 thousand and \$116 thousand, respectively.

Note 23. Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606" and all subsequent ASUs that modified Topic 606. 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 service charges on deposit accounts, ATM and check card fees, wealth management fees, and fees for other customer services. Noninterest revenue streams within the scope of Topic 606 are discussed below.

Service charges on deposit accounts

Service charges on deposit accounts consist of monthly service fees, overdraft and nonsufficient funds fees, and other deposit account related fees. The Company's performance obligation for monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts. Overdraft and nonsufficient funds fees and other deposit account related fees are transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time.

[Table of Contents](#)

ATM and check card fees

ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. ATM fees are transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Check card fees are primarily comprised of interchange fee income. Interchange fees are earned whenever the Company's debit cards are processed through card payment networks, such as Visa. The Company's performance obligation for interchange fee income is largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. In compliance with Topic 606, debit card fee income is presented net of associated expense.

Wealth management fees

Wealth management fees are primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are primarily recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month-end through a direct charge to customers' accounts. Estate management fees are based upon the size of the estate. Revenue for estate management fees are recorded periodically, according to a fee schedule, and are based on the services that have been provided.

Fees for other customer services

Fees for other customer services include check ordering charges, merchant services income, safe deposit box rental fees, and other service charges. Check ordering charges are transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Merchant services income mainly represent fees charged to merchants to process their debit and credit card transactions. The Company's performance obligation for merchant services income is largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation.

The following table presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the years ended December 31, 2020 and 2019 (in thousands):

	2020	2019
Noninterest Income		
Service charges on deposit accounts	\$ 2,028	\$ 2,926
ATM and check card fees	2,314	2,330
Wealth management fees	2,208	1,868
Fees for other customer services	983	686
Noninterest income (in-scope of Topic 606)	\$ 7,533	\$ 7,810
Noninterest income (out-of-scope of Topic 606)	692	742
Total noninterest income	<u>\$ 8,225</u>	<u>\$ 8,552</u>

Note 24. Derivative Financial Instruments

On April 21, 2020, the Company entered into two interest rate swap agreements related to its outstanding junior subordinated debt. One swap agreement was related to the Company's junior subordinated debt with a redemption date of June 17, 2034, which became effective on March 17, 2020. The notional amount of the interest rate swap was \$5.0 million and terminates on June 17, 2034. Under the terms of the agreement, the Company pays interest quarterly at a fixed rate of 0.79% and receives interest quarterly at a variable rate of three-month LIBOR. The variable rate resets on each interest payment date. The other swap agreement was related to the Company's junior subordinated debt with a redemption date of October 1, 2036, which became effective on April 1, 2020. The notional amount of the interest rate swap was \$4.0 million and terminates on October 1, 2036. Under the terms of the agreement, the Company pays interest quarterly at a fixed rate of 0.82% and receives interest quarterly at a variable rate of three-month LIBOR. The variable rate resets on each interest payment date.

The Company entered into interest rate swaps to reduce interest rate risk and to manage interest expense. By entering into these agreements, the Company converted variable rate debt into fixed rate debt. Alternatively, the Company may enter into interest rate swap agreements to convert fixed rate debt into variable rate debt. Interest differentials paid or received under interest rate swap agreements are reflected as adjustments to interest expense. The Company designated the interest rate swaps as hedging instruments in qualifying cash flow hedges, as discussed in Note 1 to the Consolidated Financial Statements. Changes in fair value of these designated hedging instruments is reported as a component of other comprehensive income. Interest rate swaps designated as cash flow hedges are expected to be highly effective in offsetting the effect of changes in interest rates on the amount of variable rate interest payments, and the Company assesses the effectiveness of each hedging relationship quarterly. If the Company determines that a cash flow hedge is no longer highly effective, future changes in the fair value of the hedging instrument would be reported as earnings. As of December 31, 2020, the Company has designated cash flow hedges to manage its exposure to variability in cash flows on certain variable rate borrowings for periods that end between June 2034 and October 2036. The notional amounts of the interest rate swaps were not exchanged and do not represent exposure to credit loss. In the event of default by a counterparty, the risk in these transactions is the cost of replacing the agreements at current market rates.

All interest rate swaps were entered into with counterparties that met the Company's credit standards and the agreements contain collateral provisions protecting the at-risk party. The Company believes that the credit risk inherent in these derivative contracts is not significant.

Unrealized gains or losses recorded in other comprehensive income related to cash flow hedges are reclassified into earnings in the same period(s) during which the hedged interest payments affect earnings. When a designated hedging instrument is terminated and the hedged interest payments remain probable of occurring, any remaining unrecognized gain or loss in other comprehensive income is reclassified into earnings in the period(s) during which the forecasted interest payments affect earnings. Amounts reclassified into earnings and interest receivable or payable under designated interest rate swaps are reported in interest expense. The Company does not expect any unrealized losses related to cash flow hedges to be reclassified into earnings in the next twelve months.

The following table summarizes key elements of the Company's derivative instruments at December 31, 2020 (in thousands):

	2020			
	Notional Amount	Assets	Liabilities	Collateral Pledged(1)
Cash Flow Hedges				
Interest rate swap contracts	\$ 9,000	\$ 431	\$ —	\$ —

(1) Collateral pledged may be comprised of cash or securities.

Note 25. Subsequent Events

On February 18, 2021, the Company entered into an agreement to acquire The Bank of Fincastle (Fincastle) for an aggregate purchase price of \$31.6 million in cash and stock. The financial position and results of operations of Fincastle are not reflected in the Company's financial statements as of December 31, 2020. At the time of closing of the acquisition, The Bank of Fincastle is expected to have six retail bank offices operating in the greater Roanoke region of Virginia, including its main office in the Town of Fincastle. As of December 31, 2020, Fincastle reported assets of \$255.9 million, loans, net of allowance for loan losses, of \$198.4 million, and deposits of \$224.3 million.

In connection with the transaction, the Company expects to pay cash consideration of \$6.7 million and issue approximately 1.3 million shares of its common stock to the shareholders of Fincastle. Upon completion of the

transaction, the Bank of Fincastle is expected to be merged with and into First Bank. The acquisition will be accounted for as a business combination under ASC 805, *Business Combinations*. Under acquisition accounting, assets acquired and liabilities assumed are recorded at their acquisition date fair values, and any excess of the purchase price over the aggregate fair value of the net assets acquired is recognized as goodwill.

Note 26. Parent Company Only Financial Statements

FIRST NATIONAL CORPORATION

(Parent Company Only)

Balance Sheets

December 31, 2020 and 2019

(in thousands)

	2020	2019
Assets		
Cash	\$ 16,440	\$ 9,778
Investment in subsidiaries, at cost, plus undistributed net income	87,109	81,399
Other assets	740	312
Total assets	<u>\$ 104,289</u>	<u>\$ 91,489</u>
Liabilities and Shareholders' Equity		
Subordinated debt	\$ 9,991	\$ 4,983
Junior subordinated debt	9,279	9,279
Other liabilities	103	8
Total liabilities	\$ 19,373	\$ 14,270
Preferred stock	\$ —	\$ —
Common stock	6,075	6,212
Surplus	6,151	7,700
Retained earnings	69,292	62,583
Accumulated other comprehensive income, net	3,398	724
Total shareholders' equity	\$ 84,916	\$ 77,219
Total liabilities and shareholders' equity	<u>\$ 104,289</u>	<u>\$ 91,489</u>

[Table of Contents](#)

FIRST NATIONAL CORPORATION

(Parent Company Only)

Statements of Income

Years Ended December 31, 2020 and 2019

(in thousands)

	2020	2019
Income		
Dividends from subsidiary	\$ 6,600	\$ 3,600
Total income	<u>\$ 6,600</u>	<u>\$ 3,600</u>
Expense		
Interest expense	\$ 794	\$ 782
Supplies	3	3
Legal and professional fees	215	137
Data processing	29	26
Management fee-subsiary	294	283
Other expense	80	103
Total expense	<u>\$ 1,415</u>	<u>\$ 1,334</u>
Income before allocated tax benefits and undistributed income of subsidiary	\$ 5,185	\$ 2,266
Allocated income tax benefit	297	280
Income before equity in undistributed income of subsidiary	\$ 5,482	\$ 2,546
Equity in undistributed income of subsidiary	<u>3,376</u>	<u>7,010</u>
Net income	<u><u>\$ 8,858</u></u>	<u><u>\$ 9,556</u></u>

[Table of Contents](#)

FIRST NATIONAL CORPORATION

(Parent Company Only)

Statements of Cash Flows

Years Ended December 31, 2020 and 2019

(in thousands)

	2020	2019
Cash Flows from Operating Activities		
Net income	\$ 8,858	\$ 9,556
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of subsidiary	(3,376)	(7,010)
Amortization of debt issuance costs	18	18
Decrease in other assets	3	2
Increase (decrease) in other liabilities	4	(2)
Net cash provided by operating activities	\$ 5,507	\$ 2,564
Cash Flows from Financing Activities		
Proceeds from subordinated debt, net of issuance costs	\$ 4,990	\$ —
Cash dividends paid on common stock, net of reinvestment	(2,007)	(1,674)
Distribution of capital to subsidiary	—	(3,500)
Net proceeds from issuance of common stock	290	183
Repurchase of common stock	(2,118)	(52)
Net cash provided by (used in) financing activities	\$ 1,155	\$ (5,043)
Increase (decrease) in cash and cash equivalents	\$ 6,662	\$ (2,479)
Cash and Cash Equivalents		
Beginning	9,778	12,257
Ending	\$ 16,440	\$ 9,778

[Table of Contents](#)

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

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company's management, including the Company's Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of December 31, 2020 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Company's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Company or its subsidiaries to disclose material information required to be set forth in the Company's periodic reports.

Management's Report on Internal Control over Financial Reporting

Management of the Company is also responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2020. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control – Integrated Framework (2013). Based on the assessment, management believes that, as of December 31, 2020, the Company's internal control over financial reporting was effective based on those criteria.

Changes in Internal Controls

There were no changes in the Company's internal control over financial reporting during the Company's fourth quarter ended December 31, 2020 that have materially affected, or are reasonably likely to materially affect, the Company's 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 2021 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.

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 [Agreement and Plan of Merger, dated as of February 18, 2021, by and between First National Corporation, First Bank, and The Bank of Fincastle \(incorporated herein by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed February 18, 2021\).](#)
 - 3.1 [Amended and Restated Articles of Incorporation, as amended and restated on March 3, 2009 \(incorporated herein by reference to Exhibit 3.1 to the Company's Form 10-K for the year ended December 31, 2008\).](#)
 - 3.3 [By-laws of First National Corporation \(as restated in electronic format as of April 1, 2020\), attached as Exhibit 3.1 to the Current Report on Form 8-K filed April 2, 2020 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) (paper filing).
 - 4.2 [Description of Securities \(incorporated herein by reference to Exhibit 4.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2019\).](#)
 - 4.3 [Form of 5.50% Fixed to Floating Rate Subordinated Note due 2030 \(incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed July 6, 2020\).](#)
 - 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 \(incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarter ended June 30, 2007\).](#)
 - 10.4 [Amendment to Employment Agreement between the Company and Dennis A. Dysart and M. Shane Bell \(incorporated by reference to Exhibit 10.6 to the Company's Form 10-K for the year ended December 31, 2008\).](#)
 - 10.8 [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 \(incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on March 19, 2013\).](#)
 - 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. \(incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on November 5, 2015\).](#)
 - 10.13 [Supplemental Executive Retirement Plan \(incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed March 21, 2019\).](#)
 - 10.14 [Supplemental Executive Retirement Plan, dated March 15, 2019, for the benefit of Scott C. Harvard \(incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, filed on March 21, 2019\).](#)
 - 10.15 [Supplemental Executive Retirement Plan, dated March 15, 2019, for the benefit of Dennis A. Dysart \(incorporated herein by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K, filed on March 21, 2019\).](#)
 - 10.16 [Supplemental Executive Retirement Plan, dated March 15, 2019, for the benefit of M. Shane Bell \(incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K, filed on March 21, 2019\).](#)
 - 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, 2020 formatted in Inline 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.
- 104 The cover page from First National Corporation's Annual Report on Form 10-K for the year ended December 31, 2020, formatted in Inline XBRL (included with Exhibit 101).

(b) Exhibits

See Item 15(a)(3) above.

(c) Financial Statement Schedules

See Item 15(a)(2) above.

Item 16. Form 10-K Summary

None.

[Table of Contents](#)

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST NATIONAL CORPORATION

By: /s/ Scott C. Harvard

President and Chief Executive Officer
(on behalf of the registrant and as principal executive officer)

Date: March 31, 2021

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>/s/ Scott C. Harvard</u> President & Chief Executive Officer Director (principal executive officer)	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ M. Shane Bell</u> Executive Vice President & Chief Financial Officer (principal financial officer and principal accounting officer)	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ Elizabeth H. Cottrell</u> Chairman of the Board of Directors	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ Gerald F. Smith, Jr.</u> Vice Chairman of the Board of Directors	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ Jason C. Aikens</u> Director	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ Emily Marlow Beck</u> Director	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ Boyce E. Brannock</u> Director	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ W. Michael Funk</u> Director	Date: <u>March 31, 2021</u>
--	-----------------------------

<u>/s/ James R. Wilkins, III</u> Director	Date: <u>March 31, 2021</u>
--	-----------------------------