2022 ANNUAL REPORT & FORM 10-K

March 30, 2023

Dear Shareholders:

It is my pleasure to present the First National Corporation Annual Report for 2022, a year of record earnings and record earnings per share. We often hear about the month of March coming in like a lion and going out like a lamb. In the case of 2022, we saw just the opposite. The year came in like a lamb with low interest rates and strong loan demand, and went out like a lion, with rates rising at the fastest pace in decades and threats of imminent recessions.

As the year began, interest rates were near record lows while inflation remained stubborn to the point the Federal Reserve took action by raising interest rates. Over the course of the year, the Federal funds rate increases impacted the yield on loans more than they impacted the rates on deposits. The lag in deposit rates combined with the Company's best year ever of organic loan growth helped drive a thirty one percent increase in net interest income. In addition, each of the Bank's top three noninterest income categories, deposit account service charges, ATM and check card fees, and wealth management fees, saw double digit growth for the year. The result was the highest net income in the 115-year history of our banking company. The details can be found in the accompanying Annual Report.

We are extremely proud of the financial results of last year, and while we attribute much to the external environment, we believe the results were driven to a large degree by two strategic initiatives that occurred during 2021. Coming out of the pandemic, the Company embarked on two significant expansion initiatives, both of which were aligned with our strategic plan. The first was the whole bank acquisition of The Bank of Fincastle, a transaction that improved scale by bolstering assets by 26%, expanded our footprint along the U.S. 81 corridor, and provided an entree into the Roanoke, Virginia MSA. The second initiative was the SmartBank team lift and loan purchase in Richmond, which was accretive to earnings from day one and bolstered the team and our presence in a significant market. The transactions were successfully executed, and the strategies were validated as the results of the initiatives exceeded expectations.

Finally, I must acknowledge our disappointment in our stock performance. Over the last year, bank stocks, including First National Corporation, have seen precipitous declines in stock price despite delivering record earnings and increasing dividends. Unfortunately, we cannot control the market's ups and downs. However, we can stay focused on running a safe and sound banking company, which we think is especially critical in today's uncertain economy. Your board and your management team continue to believe the keys to building shareholder value over time are to deliver double digit returns on equity, consistent and reliable dividends, and a growing franchise operating in highly desired markets across Virginia.

Thank you for your continued support of our banking company.

Sincerely,

Scott C. Harvard
President and CEO

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, 2022

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:

Title of each class	Trading symbol(s)	Name of each exchange on which registered
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. ☐

If securities are registered pursuant to Section 12(b) of the Act, indicate by check mark whether the financial statements of the registrant included in the filing reflect the correction of an error to previously issued financial statements. ☐

Indicate by check mark whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the registrant's executive officers during the relevant recovery period pursuant to §240.10D-1(b). ☐

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, 2022 was $95,329,016.

The number of outstanding shares of common stock as of March 17, 2023 was 6,281,935.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for the 2023 Annual Meeting of Shareholders – Part III

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Part I

Cautionary Statement Regarding Forward-Looking Statements

First National Corporation (the Company) makes forward-looking statements in this Form 10-K that are subject to risks and uncertainties. These forward-looking statements include, but are not limited to, statements regarding profitability, liquidity, adequacy of capital, allowance for loan losses, interest rate sensitivity, market risk, and growth strategy. 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:

- general business conditions, as well as conditions within the financial markets;
- general economic conditions, including unemployment levels, inflation 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;
- changes in cyber threats, attacks or events;
- the ability to maintain adequate liquidity by retaining deposit customers and secondary funding sources, especially if the Company's, or industry's, reputation 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 value of the Company's securities portfolio and its net interest income and an unfavorable impact on the Company's customers' ability to repay loans;
- geopolitical conditions, including acts or threats of terrorism, international hostilities, or actions taken by the U.S. or other governments in response to acts or threats of terrorism and/or military conflicts, which could impact business and economic conditions in the U.S. and abroad; and
- other factors identified in Item 1A, "Risk Factors", below.

Because of these and other uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results.

Item 1. Business

General

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

- First Bank (the Bank). The Bank owns:
  - First Bank Financial Service, Inc.
  - Shen-Valley Land Holdings, LLC
  - Bank of Fincastle Services, Inc.
  - ESF, 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. owns an interest in an entity that provides title insurance services. Bank of Fincastle Services, Inc. is no longer an active operating entity. Shen-Valley Land Holdings, LLC and ESF, LLC were 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 July 1, 2021, the Company completed the acquisition of The Bank of Fincastle (Fincastle) for an aggregate purchase price of $33.8 million of cash and stock. On September 30, 2021, the Bank acquired $82.0 million of loans and certain fixed assets from SmartBank related to its Richmond area branch. The Bank purchased the fixed assets for an amount equal to SmartBank's book value. Additional information about these acquisitions is presented in Note 25.

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, the Roanoke 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 20 bank branch offices, a loan production office and two customer service centers in retirement communities. 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.

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, 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, 2022, the Bank was ranked second overall in its market area with 12.39% of its 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, 2022, the Bank employed a total of 215 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.

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.

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's Bureau of Financial Institutions. 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.

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, 2022 and December 31, 2021, 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, 2022:

	First Bank
Total capital to risk-weighted assets	14.60%
Tier 1 capital to risk-weighted assets	13.82%
Common equity Tier 1 capital to risk-weighted assets	13.82%
Tier 1 capital to average assets	9.36%
Capital conservation buffer ratio(1)	6.60%

(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, 2022 and December 31, 2021.

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 4”). 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 are to become effective on January 1, 2023, with an aggregate output floor phasing-in through January 1, 2028. 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 4 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. 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 has not opted into the CBLR framework, it may opt into the CBLR framework in a future quarterly period.

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. The deposit insurance assessment base is based on 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%. On October 18, 2022, the FDIC adopted a final rule to increase base deposit insurance assessment rate schedules uniformly by 2 basis points beginning in the first quarterly assessment period of 2023. The increase is being instituted to account for extraordinary growth in insured deposits during the first and second quarters of 2020, which caused a substantial decrease in the “reserve ratio” of the DIF to total industry deposits. The FDIC has indicated that the new assessment rate schedules will remain in effect until the DIF reserve ratio meets or exceeds 2 percent.

FDIC 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) are calculated based on risk-based assessments using examination rulings and financial modeling 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.

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, 2022.

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 2021, the most recent notification from the Federal Reserve, the Bank received a "satisfactory" CRA rating.

In May 2022, the federal bank regulatory agencies jointly issued a proposed rule intended to strengthen and modernize the CRA regulatory framework. If implemented, the rule would, among other things, (i) expand access to credit, investment and basic banking services in low- and moderate-income communities, (ii) adapt to changes in the banking industry, including internet and mobile banking, (iii) provide greater clarity, consistency and transparency in the application of the regulations and (iv) tailor performance standards to account for differences in bank size, business model, and local conditions.

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.

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 November 2021, the federal banking agencies approved a final rule that requires banking organizations to notify their primary regulator within 36 hours of becoming aware of a "computer-security incident" that rises to the level of a "notification incident", among other things, the rule also requires bank service providers to notify their banking organization customers as soon as possible after becoming 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, 2022, the Company had not been made aware of any instances of non-compliance with the guidance.

CARES Act. In response to the COVID-19 pandemic, the Coronavirus Aid, Relief and Economic Security Act (CARES Act) was signed into law on March 27, 2020. Among other things, the CARES Act included the 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.

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 our Lending Activities and Economic Conditions

Our business is subject to various lending and other economic risks that could adversely affect our results of operations and financial condition.

Deterioration in economic conditions could adversely affect our business. Our business is directly affected by general economic and market conditions; broad trends in industry and finance; legislative and regulatory changes; changes in governmental monetary and fiscal policies; changes in interest rates; and inflation, all of which are beyond our control. Although the domestic and global economies have largely recovered from the COVID-19 pandemic, certain consequences of the pandemic continue to impact the macroeconomic environment and may persist for some time. For example, the COVID-19 pandemic could have long-lasting impacts certain industries due to changes in consumer behavior and business practices, including remote work and business travel. Further, the growth in economic activity and in the demand for goods and services, coupled with labor shortages, supply chain disruptions and other factors, has contributed to rising inflationary pressures, the Federal Reserve's responsive interest rate hikes, and the risk of recession. A deterioration in economic conditions, in particular a prolonged economic slowdown within our geographic region or a broader disruption in the economy, including as a result of a pandemic or other widespread public health emergency, could result in the following consequences, any of which could hurt our business materially: an increase in loan delinquencies; an increase in problem assets and foreclosures; a decline in demand for our products and services; a deterioration in the value of collateral for loans made by our various business segments; and changes in the fair value of financial instruments held by the Company or its subsidiaries.

Adverse changes in economic conditions in our market areas or adverse conditions in an industry on which a local market in which we do business is dependent could adversely affect our results of operations and financial condition.

We provide full-service banking and other financial services throughout the Company's market areas, which include the Shenandoah Valley, Roanoke Valley, Richmond, and central regions of Virginia. Our loan and deposit activities are directly affected by, and our financial success depends on, economic conditions within these markets, as well as conditions in the industries on which those markets are economically dependent. A deterioration in local economic conditions or in the condition of an industry on which a local market depends could adversely affect such factors as unemployment rates, business formations and expansions and housing market conditions. Adverse developments in any of these factors could result in among other things, a decline in loan demand, a reduction in the number of credit-worthy borrowers seeking loans, an increase in delinquencies, defaults and foreclosures, an increase in classified and nonaccrual loans, a decrease in the value of loan collateral, and a decline in the financial condition of borrowers and guarantors, any of which could adversely affect our financial condition or business.

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.

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 commercial 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.

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 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.

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.

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.

Weakness in the secondary residential mortgage loan markets or demand for mortgage loans may adversely affect income.

Our mortgage department contributes to our noninterest income. We generate income from brokered mortgage loans and gains on sales of mortgage loans primarily from loans that we source and/or originate. Interest rates, housing inventory, housing demand, cash buyers, new mortgage lending regulations and other market conditions have a direct effect on loan originations across the industry. During 2022, revenues from mortgage banking decreased significantly, primarily due to lower mortgage volumes as market interest rates increased and the demand for mortgages declined. Loan production levels may continue to suffer if there is a sustained slowdown in the housing markets in which the Company conducts business or tightening credit conditions. Any sustained period of decreased activity caused by an economic downturn, fewer refinancing transactions, higher interest rates, housing price pressure, or loan underwriting restrictions would adversely affect the Company's mortgage originations and, consequently, noninterest income from its mortgage operations. In addition, our results of operations are affected by the amount of noninterest expenses (including for personnel and systems infrastructure) associated with mortgage banking activities. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in mortgage loan origination activity.

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.

<u>Risks Related to our Industry</u>

We are subject to interest rate risk and fluctuations in interest rates may negatively affect our results of operations and financial condition.

Our profitability depends in substantial part on our net interest margin, which is the difference between the interest earned on loans, securities and other interest-earning assets, and interest paid on deposits and borrowings divided by total interest-earning assets. Changes in interest rates will affect our net interest margin in diverse ways, including the pricing of loans and deposits, the levels of prepayments, and asset quality. We are unable to predict actual fluctuations of market interest rates because many factors influencing interest rates, including changes in economic conditions and monetary policies, which are beyond our control. We believe that our current interest rate exposure is manageable and does not indicate any significant exposure to interest rate changes. Although the Company does not believe it has significant exposure to changes in interest rates, it could experience pressure on the net interest margin due to intense competition for loans and deposits from both local and national financial institutions. In addition, the Company could experience net interest margin compression if it is unable to maintain its current level of loans outstanding by continuing to originate new loans or if it experiences a decrease in deposit balances, which would require the Company to seek funding from other sources at higher rates of interest.

In addition, changes in interest rates may negatively affect both the returns on and market value of our investment securities. As we experienced due to rising interest rates in 2022, interest rate changes can reduce unrealized gains or increase unrealized losses in our portfolio and thereby negatively impact our accumulated other comprehensive income and equity levels. Further, such losses could be realized into earnings should liquidity and/or business strategy necessitate the sales of securities in a loss position. Additionally, actual investment income and cash flows from investment securities that carry prepayment risk, such as mortgage-backed securities and callable securities, may materially differ from those anticipated at the time of investment or subsequently as a result of changes in interest rates and market conditions. These occurrences could have a material adverse effect on our net interest income or our results of operations.

We rely substantially on deposits obtained from customers in our target markets to provide liquidity and support growth.

We require sufficient liquidity to fund asset growth, meet customer loan requests, customer deposit maturities and withdrawals, make payments on our debt obligations as they come due and other cash commitments. Our business strategy is based primarily on access to funding from local customer deposits. Deposit levels may be affected by a number of factors, including interest rates paid by competitors, general interest rate levels, returns available to customers on alternative investments, changes in the liquidity needs of our depositors and general economic conditions that affect savings levels and the amount of liquidity in the economy, including government stimulus efforts in response to economic crises. If market interest rates rise or our competitors raise the rates they pay on deposits, our funding costs may increase, either because we raise our rates to avoid losing deposits or because we lose deposits and must rely on more expensive sources of funding. Either of these factors could reduce our net interest margin and net interest income and could have a material adverse effect on our business, financial condition, results of operations and cash flows from operations.

Further, if local customer deposits are not sufficient to fund our normal operations and growth, we may rely on secondary sources of liquidity, such as brokered deposits, borrowings from the Federal Home Loan Bank of Atlanta (FHLB), federal funds lines of credit from correspondent banks, and borrowings from the Federal Reserve Discount Window; however, there can be no assurance that these arrangements will be available to us when needed on favorable terms, or at all, or that they will be sufficient to meet future liquidity needs. For example, our ability to access borrowings from the FHLB will be dependent upon whether and the extent to which we can provide collateral to secure FHLB borrowings, and our use of brokered deposits may be limited or discouraged by our banking regulators. We also may need to raise funds through the issuance of debt or equity securities, or the sale of investment securities or loans, as additional sources of liquidity. If we are unable to access funding sufficient to support our business operations and growth strategies or are unable to access such funding on attractive terms, we may not be able to implement our business strategies or satisfy our obligations.

Consumers may increasingly decide not to use banks to complete their financial transactions, which could have a material adverse impact on our financial condition and operations.

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

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 may 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 the 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 performs 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.

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.

Risks Related to Operations and Technology

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.

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.

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.

Our business is technology dependent, and an inability to successfully implement technological improvements may adversely affect our ability to be competitive and our results of operations and financial condition.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products, systems and services, which may require substantial initial investment to be implemented, including the cost of modifying or adapting existing products, systems and services. The Company invests in new technology to enhance customer service, and to increase efficiency and reduce operating costs. Our future success will depend in part upon our ability to create synergies in our operations through the use of technology and to facilitate the ability of customers to engage in financial transactions in a manner that enhances the customer experience. We cannot give any assurance that technological improvements will increase operational efficiency or that we will be able to effectively implement new technology-driven products, systems and services or be successful in marketing new products and services to our customers. A failure to maintain or enhance a competitive position with respect to technology, whether because of a failure to anticipate customer expectations, substantially fewer resources to invest in technological improvements than larger competitors, or because our technological developments fail to perform as desired or are not implemented in a timely manner, could result in higher operating costs, decreased customer satisfaction, and lower market share. An inability to effectively implement new technology and realize operational efficiencies could result in the loss of initial investments in such projects and higher operating costs. Either of these outcomes could have a material adverse impact on our financial condition and results of operations.

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 believe the Company has excellent employee relations and provides competitive compensation to its 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.

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.

Difficulties in combining the operations of new or acquired bank branches, loan production offices 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 loan production office (LPO) or through an acquisition. Inherent uncertainties exist in integrating the operations of a new or acquired entity or acquired branches or LPO's. In addition, the markets and industries in which the Company and its potential new office 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 office 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 or LPO locations or acquisitions within desired time frames, or at all. Future business acquisitions could be material to the Company, and it may issue additional shares of common stock to support those acquisitions, which would dilute current shareholders' ownership interests. Acquisitions could also require the Company to use substantial cash or other liquid assets or to incur debt; the Company could therefore become more susceptible to economic downturns and competitive pressures.

The 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.

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 controls that require remediation. A "material weakness" is a deficiency, or a combination of deficiencies, in internal controls 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 or any of its subsidiaries is a defendant from time to time in a variety of litigation and other actions.

The Company or any of its subsidiaries may be involved from time to time in a variety of litigation arising out of its business, and the Company operates in a legal and regulatory environment that exposes it to potential significant litigation risk. The Company's insurance may not cover all claims that may be asserted against it in legal or administrative actions or costs that it may incur defending such actions, and any claims asserted against it, regardless of merit or eventual outcome, may harm the Company's reputation. Should the ultimate judgments or settlements and/or costs incurred in any litigation exceed any applicable insurance coverage, they could have a material adverse effect on the Company's financial condition and results of operation for any period.

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 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 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.

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, cause economic or market uncertainty, negatively impact consumer confidence, 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.

Risks Related to the Regulation of the Company

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.

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 significant regulatory changes, the Dodd-Frank Act 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.

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 Company is subject to stringent capital and liquidity requirements as a result of the Basel III regulatory capital reforms and the Dodd-Frank Act, which could adversely affect our results of operations and future growth.

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 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. For example, effective January 1, 2023, the Company adopted Accounting Standards Codification 326, Financial Instruments - Credit Losses, commonly referred to as CECL. CECL is generally viewed throughout the industry as the most significant change in accounting standards to affect financial institutions in decades, as it fundamentally changes the accounting for and estimation of the allowance for loan losses. The current incurred loss approach was replaced by a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. As a result, the Company has incurred additional expenses to support both the adoption and the subsequent accounting and financial reporting requirements of CECL. For more information regarding recent accounting pronouncements and their effects on the Company, including CECL, see "Recent Accounting Pronouncements" in Note 1 of the consolidated financial included in Item 8 of this Form 10-K.

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 are 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 is transitioning from the use of the LIBOR index in the future.

In 2017, the United Kingdom's Financial Conduct Authority announced that after 2021 it would no longer compel banks to submit the rates required to calculate LIBOR. 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.

Regulators, industry groups, and certain committees (e.g., the Alternative Reference Rates Committee) have, among other things, published recommended fall-back language for LIBOR-linked financial instruments, identified recommended alternatives for certain LIBOR rates (e.g., SOFR, as the recommended alternative to U.S. Dollar LIBOR), and proposed implementations of the recommended alternatives in floating rate instruments. The Adjustable Interest Rate (LIBOR) Act (the "LIBOR Act"), enacted in March 2022, provides a statutory framework to replace LIBOR with a benchmark rate based on SOFR for contracts governed by U.S.

law that have no or ineffective fallbacks. Although governmental authorities have endeavored to facilitate an orderly discontinuation of LIBOR, no assurance can be provided that this aim will be achieved or that the use, level, and volatility of LIBOR or other interest rates or the value of LIBOR-based securities will not be adversely affected. For example, SOFR is a relatively new reference rate, has a very limited history, and differs fundamentally from U.S. Dollar LIBOR. SOFR is a broad U.S. Treasury repo financing rate that represents overnight secured funding transactions, whereas U.S. Dollar LIBOR is an unsecured rate that represents interbank funding over different maturities. As a result, there can be no assurance that SOFR will perform in the same way as U.S. Dollar LIBOR would have done at any time, and there is no guarantee that it is a comparable substitute for U.S. Dollar LIBOR. The implementation of a substitute index or indices for the calculation of interest rates under the Company's loan agreements with borrowers, subordinated notes that it has issued, or other financial arrangements may cause the Company to incur significant expenses in effecting the transition, may result in reduced loan balances if borrowers do not accept the 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.

Increasing scrutiny and evolving expectations from customers, regulators, investors, and other stakeholders with respect to environmental, social and governance (ESG) practices may impose additional costs on the Company or expose it to new or additional risks.

Companies are facing increasing scrutiny from customers, regulators, investors, and other stakeholders related to ESG practices and disclosure. Investor advocacy groups, investment funds, and influential investors are also increasingly focused on these practices, especially as they relate to climate risk, hiring practices, the diversity of the work force, and racial and social justice issues. Increased ESG related compliance costs could result in increases to the Company's overall operational costs. Failure to adapt to or comply with regulatory requirements or investor or stakeholder expectations and standards could negatively impact the Company's reputation, ability to do business with certain partners, and the Company's stock price. New government regulations could also result in new or more stringent forms of ESG oversight and expanding mandatory and voluntary reporting, diligence, and disclosure.

Climate change and related legislative and regulatory initiatives may result in operational changes and expenditures that could significantly impact the Company's business.

The current and anticipated effects of climate change are creating an increasing level of concern for the state of the global environment. As a result, political and social attention to the issue of climate change has increased. Federal and state legislatures and regulatory agencies have continued to propose and advance numerous legislative and regulatory initiatives seeking to mitigate the effects of climate change. The federal banking agencies have emphasized that climate-related risks are faced by banking organizations of all types and sizes and are in the process of enhancing supervisory expectations regarding banks' risk management practices. In December 2021, the Office of the Comptroller of the Currency (OCC) published proposed principles for climate risk management by banking organizations with more than $100 billion in assets. The OCC also has appointed its first ever Climate Change Risk Officer and established an internal climate risk implementation committee in order to assist with these initiatives and to support the agency's efforts to enhance its supervision of climate change risk management. Similar and even more expansive initiatives are expected, including potentially increasing supervisory expectations with respect to banks' risk management practices, accounting for the effects of climate change in stress testing scenarios and systemic risk assessments, revising expectations for credit portfolio concentrations based on climate-related factors and encouraging investment by banks in climate-related initiatives and lending to communities disproportionately impacted by the effects of climate change. To the extent that these initiatives lead to the promulgation of new regulations or supervisory guidance applicable to the Company, the Company would likely experience increased compliance costs and other compliance-related risks.

The lack of empirical data surrounding the credit and other financial risks posed by climate change render it impossible to predict how specifically climate change may impact the Company's financial condition and results of operations; however, the physical effects of climate change may also directly impact the Company. Specifically, unpredictable and more frequent weather disasters may adversely impact the value of real property securing the loans in the Bank's loan portfolio. Additionally, if insurance obtained by borrowers is insufficient to cover any losses sustained to the collateral, or if insurance coverage is otherwise unavailable to borrowers, the collateral securing loans may be negatively impacted by climate change, which could impact the Company's financial condition and results of operations. Further, the effects of climate change may negatively impact regional and local economic activity, which could lead to an adverse effect on customers and impact the communities in which the Company operates. Overall, climate change, its effects and the resulting, unknown impact could have a material adverse effect on the Company's financial condition and results of operations.

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.

Future sales of our common stock by shareholders or the perception that those sales could occur may cause our common stock price to decline.

Although our common stock is listed for trading on NASDAQ Capital Market stock exchange, the trading volume in our common stock may be lower than that of other larger financial institutions. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the potential for lower relative trading volume in our common stock, significant sales of the common stock in the public market, or the perception that those sales may occur, could cause the trading price of our common stock to decline or to be lower than it otherwise might be in the absence of these sales or perceptions.

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.

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, 2022, the Bank operated 20 branches throughout the Shenandoah Valley, central regions of Virginia, and the Richmond and Roanoke market areas. The Bank also operates a loan production office and two customer service centers in retirement communities. 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 17, 2023 the Company had 808 shareholders of record and approximately 1,022 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 2022, the Board of Directors of the Company authorized a stock repurchase plan pursuant to which the Company may repurchase up to $5.0 million of its outstanding common stock. Repurchases under the plan could be 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, 2023, unless the entire amount authorized to be repurchased had been acquired before that date. As of December 31, 2022, the Company had not repurchased common stock under the purchase plan.

Item 6. [Reserved]

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, 2022 and 2021 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

<u>The Company</u>

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
- Bank of Fincastle Services, Inc.
- ESF, 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. owns an interest in an entity that provides title insurance services. Bank of Fincastle Services, Inc. is no longer an active operating entity. Shen-Valley Land Holdings, LLC and ESF, LLC were 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, Roanoke Valley, central regions of Virginia, and the Richmond market areas. Within these market areas, there are diverse types of industry including regional medical, professional services, manufacturing, retail, warehousing, Federal government, hospitality, and higher education. The Bank's products and services are delivered through 20 bank branch offices, mobile banking platform, website, www.fbvirginia.com, a loan production office, and two customer service centers in retirement communities. The Bank's services are also delivered through a network of ATMs located throughout its market area. For the location and general character of each of these offices, see Item 2 of this Form 10-K.

Revenue Sources and Expense Factors

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

Primary expense categories are salaries and employee benefits, which comprised 58% of noninterest expenses during 2022, followed by occupancy and equipment expense, which comprised 13% 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.

Overview of Financial Performance and Condition

Net income increased by $6.4 million to $16.8 million, or $2.68 per diluted share, for the year ended December 31, 2022, compared to $10.4 million, or $1.86 per diluted share, for the same period in 2021. Return on average assets was 1.19% and return on average equity was 15.87% for the year ended December 31, 2022, compared to 0.88% and 10.30%, respectively, for the year ended December 31, 2021.

The $6.4 million increase in net income for the year ended December 31, 2022 resulted primarily from a $10.7 million, or 31%, increase in net interest income, and a $2.5 million, or 24%, increase in noninterest income, compared to the same period of 2021. These favorable variances were partially offset by a $2.5 million increase in provision for loan losses, a $2.9 million, or 9%, increase in noninterest expense and a $1.4 million increase in income tax expense.

Net interest income increased $10.7 million, or 31%, for the year ended December 31, 2022, compared to the same period of 2021 from a $12.3 million increase in total interest income, which was partially offset by a $1.5 million increase in total interest expense. Net interest income increased from a 31-basis point expansion of the net interest margin to 3.44% and a $212.0 million, or 19%, increase in average earning assets. The merger of The Bank of Fincastle with and into First Bank on July 1, 2021 contributed to the increase in average earning assets.

Accretion of loan discounts, net of premium amortization on acquired loans, which was included in interest income, increased by $722 thousand to $1.1 million in 2022. While accretion on loan discounts increased, accretion of deferred PPP loan income, net of origination costs, which was also included in interest income, decreased by $1.6 million to $358 thousand in 2022.

The provision for loan losses increased $2.5 million, which resulted from a provision for loan losses of $1.9 million in 2022 compared to a $650 thousand recovery of loan losses in 2021. The allowance for loan losses totaled $7.4 million, or 0.81% of total loans, at December 31, 2022, compared to $5.7 million, or 0.69% of total loans, at December 31, 2021. The specific reserve increased $833 thousand, and the general reserve increased $903 thousand compared to the prior year. Net charge-offs totaled $114 thousand in 2022 and $1.1 million in 2021.
Noninterest income increased $2.4 million, primarily from a gain of $2.9 million recognized from the sale of an interest in a company owned by First Bank Financial Services, Inc. Other notable increases include service charges on deposit accounts, ATM and check

card fees, wealth management fees, and other operating income totaling $616 thousand, $370 thousand, $296 thousand, and $549 thousand, respectively. The increases in these noninterest income categories were partially offset by a $2.0 million net loss on the sale of securities available for sale.

Noninterest expense increased $2.9 million, or 9%, and was impacted by the first full year of operations after the merger of The Bank of Fincastle with and into First Bank on July 1, 2021, as well as the addition of employees, a loan production office, and customer accounts that resulted from the acquisition of the SmartBank banking office on September 30, 2021. Several noninterest expense categories increased compared to the prior year, including salaries and employee benefits, occupancy, equipment, bank franchise tax and other operating expenses. The increases were partially offset by decreases in data processing and legal and professional fees.

The following is selected financial data for the Company for the years ended December 31, 2022 and 2021. 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,	2022	2021
Results of Operations		
Interest and dividend income	$ 49,395	$ 37,144
Interest expense	3,820	2,304
Net interest income	45,575	34,840
Provision for (recovery of) loan losses	1,850	(650)
Net interest income after provision for loan losses	43,725	35,490
Noninterest income	12,621	10,172
Noninterest expense	35,597	32,717
Income before income taxes	20,749	12,945
Income tax expense	3,952	2,586
Net income	$ 16,797	$ 10,359
Key Performance Ratios		
Return on average assets	1.19%	0.88%
Return on average equity	15.87%	10.30%
Net interest margin (1)	3.44%	3.13%
Efficiency ratio (1)	61.75%	64.44%
Dividend payout	20.85%	25.69%
Equity to assets	7.91%	8.42%
Per Common Share Data		
Net income, basic	$ 2.69	$ 1.87
Net income, diluted	2.68	1.86
Cash dividends	0.56	0.48
Book value at period end	16.79	18.28
Financial Condition		
Assets	$ 1,369,383	$ 1,389,437
Loans, net	913,077	819,408
Securities	317,973	324,749
Deposits	1,241,332	1,248,752
Shareholders’ equity	108,360	117,039
Average shares outstanding, diluted	6,259	5,559
Capital Ratios (2)		
Leverage	9.36%	8.82%
Risk-based capital ratios:		
Common equity Tier 1 capital	13.82%	14.09%
Tier 1 capital	13.82%	14.09%
Total capital	14.60%	14.76%

(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. In addition, these non-GAAP financial measures may be calculated differently and may not be comparable to similar measures provided by other companies. 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.

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

Acquisition of The Bank of Fincastle

On July 1, 2021, the Company completed the acquisition of The Bank of Fincastle for an aggregate purchase price of $33.8 million of cash and stock. The Company paid cash consideration of $6.8 million and issued 1,348,065 shares of its common stock to the shareholders of Fincastle. Upon completion of the transaction, Fincastle was merged with and into First Bank. At the time of closing of the acquisition, The Bank of Fincastle had six bank branch offices operating in the Roanoke Valley region of Virginia and reported total assets of $267.9 million, total loans of $194.5 million and total deposits of $236.3 million. For the year ended December 31, 2021, the Company recorded merger related expenses of $3.4 million in connection with the acquisition of Fincastle. The Company incurred an additional $69 thousand of merger related expenses in the first and second quarters of 2022. After the merger, the former Fincastle branches continued to operate as The Bank of Fincastle, a division of First Bank, until the systems were converted on October 16, 2021 when the branch offices began operating under the First Bank name. Purchased performing loans were recorded at fair value, including a credit discount which is being accreted as an adjustment to yield over the estimated lives of the loans.

Acquisition of SmartBank Loan Portfolio

On September 30, 2021, the Bank acquired $82.0 million of loans and certain fixed assets from SmartBank related to its Richmond area branch, located in Glen Allen, Virginia. First Bank paid cash consideration of $83.7 million for the loans and fixed assets. Additionally, an experienced team of bankers based out of the SmartBank location have transitioned to become employees of First Bank. First Bank did not assume any deposit liabilities from SmartBank in connection with the transaction, and SmartBank closed their branch operation on December 31, 2021. First Bank assumed the facility lease at the branch on December 31, 2021 and operates a loan production office in the location of the former SmartBank branch. The Company incurred expenses totaling $101 thousand related to the acquisition of loans and fixed assets of SmartBank in the fourth quarter of 2021 and did not incur any additional acquisition expenses in 2022. Purchased performing loans were recorded at fair value, including a credit discount which is being accreted as an adjustment to yield over the estimated lives of the loans.

Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO expense, amortization of intangibles, merger expenses, 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	
	2022	2021
Noninterest expense	$ 35,597	$ 32,732
Subtract: other real estate owned income (expense), net	106	(26)
Subtract: amortization of intangibles	(19)	(28)
Subtract: merger related expenses	(69)	(3,514)
	$ 35,615	$ 29,164
Tax-equivalent net interest income	$ 45,906	$ 35,120
Noninterest income	12,621	10,172
Loss (gain) on disposal of premises and equipment	29	(37)
Gain on sale of other investment	(2,885)	—
Securities losses (gains), net	2,004	—
	$ 57,675	$ 45,255
Efficiency ratio	61.75%	64.44%

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 2022 and 2021 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	
	2022	**2021**
GAAP measures:		
Interest income - loans	$ 41,720	$ 32,797
Interest income - investments and other	7,675	4,347
Interest expense - deposits	(3,273)	(1,415)
Interest expense – subordinated debt	(277)	(619)
Interest expense – junior subordinated debt	(270)	(270)
Total net interest income	$ 45,575	$ 34,840
Non-GAAP measures:		
Tax benefit realized on non-taxable interest income - loans	$ 5	$ 32
Tax benefit realized on non-taxable interest income - municipal securities	326	248
Total tax benefit realized on non-taxable interest income	$ 331	$ 280
Total tax-equivalent net interest income	$ 45,906	$ 35,120

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.

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.

<u>Loans Acquired in a Business Combination</u>

Acquired loans are classified as either (i) purchased credit-impaired (PCI) loans or (ii) purchased performing loans and are recorded at fair value on the date of acquisition. PCI loans are those for which there is evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the Corporation will not collect all contractually required principal and interest payments. When determining fair value, PCI loans may be evaluated individually or may be aggregated into pools of loans based on common risk characteristics as of the date of acquisition such as loan type, date of origination, and evidence of credit quality deterioration such as internal risk grades and past due and nonaccrual status. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the "nonaccretable difference." Any excess of

cash flows expected at acquisition over the estimated fair value is referred to as the "accretable yield" and is recognized as interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows. There were no acquired loans classified as PCI in the acquisition of Fincastle and the SmartBank loan portfolio acquisition during the third quarter of 2021.

Purchased performing loans are those for which there is no evidence of credit deterioration. When determining fair value for purchased performing loans acquired from the Bank of Fincastle and SmartBank during 2021, First Bank evaluated the loans individually and they were initially recorded at fair value on the date of the acquisitions. Overall, there were net discounts recorded for the acquired loans, which are being accreted into income over the life of the loans through interest and fees on loans. The Bank calculated a required allowance for loan loss for each purchased performing loan on a quarterly basis. Provision for loan losses were recorded for purchased performing loans for the amount of the required allowance for loan losses that exceeded the unaccreted discount.

Goodwill

The Company's goodwill was recognized in connection with business combinations that occurred in the third quarter of 2021. The Company reviews the carrying value of goodwill at least annually or more frequently if certain impairment indicators exist. In testing goodwill for impairment, the Company first considers qualitative factors to determine whether the existence of events or circumstances lead to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events and circumstances, the Company concludes that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then no further testing would be required and the goodwill of the reporting unit would not be impaired. If the Company elects to bypass the qualitative assessment or if we conclude that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the fair value of the reporting unit will be compared with its carrying value to determine whether an impairment exists. The Company evaluated goodwill as of June 30, 2022 and determined there was no impairment.

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 the Bank's legal lending limit. The Board Loan Committee reviews all loans greater than $1.0 million. 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, concentrations of credit, policy exceptions, and risk grade migration. The Board Loan Committee meets at least two times per quarter 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, 2022, commitments to extend credit, stand-by letters of credit, and rate lock commitments totaled $177.2 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.

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.

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, noninterest expense and income tax expense are the other components that determine net income. Noninterest income and expense primarily consists of income from service charges on deposit accounts, ATM and check card income, wealth management income, income from other customer services, income from bank owned life insurance, general and administrative expenses, and amortization expense.

Net Interest Income

Net interest income increased $10.7 million, or 31%, for the year ended December 31, 2022, compared to the same period of 2021 from a $12.3 million increase in total interest income, which was partially offset by a $1.5 million increase in total interest expense. The net interest margin expanded by 31-basis points to 3.44% and average earnings assets increased by $212.0 million, or 19%, which both contributed to the increase in net interest income. The merger of Fincastle with and into the Bank on July 1, 2021, contributed to the increase in average earning assets.

Accretion of loan discounts, net of premium amortization on acquired loans, increased by $722 thousand compared to the prior year and totaled $1.1 million in 2022. While accretion on loan discounts increased, accretion of deferred PPP loan income, net of origination costs, which was also included in interest income, decreased by $1.6 million compared to the prior year and totaled $359 thousand in 2022.

Total interest income increased $12.3 million, or 33%, and was attributable to a $212.0 million, or 19%, increase in average earning assets and a 39-basis point increase in the yield on total earning assets. Total interest expense increased by $1.5 million, or 66%, from a $141.8 million, or 19%, increase in average interest-bearing liabilities and a 12-basis point increase in the cost of total interest-bearing liabilities. The merger of Fincastle with and into the Bank on July 1, 2021, contributed to the increases in average earning assets and average interest-bearing liabilities. The increases in the yield on total earning assets and cost of interest-bearing liabilities were impacted by the increases in market interest rates, including the Federal funds rate, which increased from 0.25% to 4.50%, at the high end of the Federal funds rate range, during the year ended December 31, 2022.

The increase in total interest income over the prior year was a result of an $8.9 million increase in interest and fees on loans, a $2.3 million increase in interest and dividends on securities, and a $1.0 million increase in interest on deposits in banks. Interest and fees on loans increased from a $160.3 million increase in average loans and a 17-basis point increase in the yield on loans. Interest and dividends on securities increased from a $129.2 million increase in average total securities, which was partially offset by a 3-basis point decrease in the yield on total securities. Interest on deposits in banks increased from a 101-basis point increase in yield and was partially offset by a $56.6 million decrease in the average balance of deposits in banks.

The increase in total interest expense over the prior year was a result of a $1.9 million increase in interest expense on deposits, which was partially offset by a $342 thousand decrease in interest expense on subordinated debt. Interest expense on deposits increased from a $146.4 million increase in average interest-bearing deposits and an 18-basis point increase in the cost of interest-bearing deposits. Interest expense on subordinated debt decreased from a decrease in the average balance of subordinated debt and a 105 basis points decrease in the cost of subordinated debt as the Company repaid $5.0 million of subordinated debt on January 1, 2022.

The following table provides information on average interest-earning assets and interest-bearing liabilities for the years ended December 31, 2022 and 2021 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,					
	2022			2021		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets						
Interest-bearing deposits in other banks	$ 107,530	$ 1,223	1.14%	$ 164,118	$ 213	0.13%
Securities:						
Taxable	284,380	5,131	1.80%	173,363	3,100	1.79%
Tax-exempt (1)	65,836	1,555	2.36%	47,570	1,184	2.49%
Restricted	1,887	92	4.87%	1,926	88	4.56%
Total securities	352,103	6,778	1.93%	222,859	4,372	1.96%
Loans: (2)						
Taxable	872,440	41,700	4.78%	709,347	32,677	4.61%
Tax-exempt (1)	548	25	4.49%	3,389	152	4.49%
Total loans	872,988	41,725	4.78%	712,736	32,829	4.61%
Federal funds sold	1	—	2.25%	20,934	10	0.05%
Total earning assets	1,332,622	49,726	3.73%	1,120,647	37,424	3.34%
Less: allowance for loan losses	(6,013)			(6,316)		
Total nonearning assets	82,101			68,105		
Total assets	$1,408,710			$1,182,436		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Checking	$ 295,530	$ 1,394	0.47%	$ 254,077	$ 424	0.17%
Money market accounts	218,783	930	0.43%	168,932	187	0.11%
Savings accounts	205,532	173	0.08%	164,768	107	0.07%
Certificates of deposit:						
Less than $100	74,616	345	0.46%	69,904	310	0.44%
Greater than $100	62,036	428	0.69%	52,304	385	0.74%
Brokered deposits	556	3	0.57%	650	2	0.34%
Total interest-bearing deposits	857,053	3,273	0.38%	710,635	1,415	0.20%
Federal funds purchased	1	—	2.27%	1	—	0.47%
Subordinated debt	5,379	277	5.15%	9,992	619	6.20%
Junior subordinated debt	9,279	270	2.91%	9,279	270	2.91%
Other borrowings	—	—	—%	0	—	0.00%
Total interest-bearing liabilities	871,712	3,820	0.44%	729,907	2,304	0.32%
Noninterest-bearing liabilities						
Demand deposits	426,823			348,829		
Other liabilities	4,306			3,104		
Total liabilities	1,302,841			1,081,840		
Shareholders' equity	105,869			100,596		
Total liabilities and shareholders' equity	$1,408,710			$1,182,436		
Net interest income		$ 45,906			$ 35,120	
Interest rate spread			3.29%			3.02%
Cost of funds			0.29%			0.21%
Interest expense as a percent of average earning assets			0.29%			0.21%
Net interest margin			3.44%			3.13%

(1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 21%. The tax-equivalent adjustment was $331 thousand for 2022, and $280 thousand for 2021

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

	Volume and Rate		
	Years Ending December 31,		
	2022		
	Volume Effect	Rate Effect	Change in Income/Expense
Interest-bearing deposits in other banks	$ (96)	$ 1,106	$ 1,010
Loans, taxable	7,777	1,247	9,024
Loans, tax-exempt	(127)	(1)	(128)
Securities, taxable	1,202	829	2,031
Securities, tax-exempt	292	79	371
Securities, restricted	(2)	6	4
Federal funds sold	—	(10)	(10)
Total earning assets	$ 9,046	$ 3,256	$ 12,302
Checking	$ 82	$ 888	$ 970
Money market accounts	68	675	743
Savings accounts	42	24	66
Certificates of deposits:			
Less than $100	21	14	35
Greater than $100	67	(24)	43
Brokered deposits	—	1	1
Federal funds purchased	—	—	—
Subordinated debt	(250)	(92)	(342)
Junior subordinated debt	—	—	—
Other borrowings	—	—	—
Total interest-bearing liabilities	$ 30	$ 1,486	$ 1,516
Change in net interest income	$ 9,016	$ 1,770	$ 10,786

Provision for Loan Losses

Provision for loan losses totaled $1.9 million for the year ended December 31, 2022, and resulted in an allowance for loan losses that totaled $7.4 million, or 0.81% of total loans. This compared to a recovery of loan losses of $650 thousand for the year ended December 31, 2021, and an allowance for loan losses of $5.7 million, or 0.69% of total loans at December 31, 2021. The increase in the allowance for loan losses resulted from an increase in both the general and specific reserve components.

For the year ended December 31, 2022, provision for loan losses of $1.9 million and net charge offs of $114 thousand resulted in a $1.7 million increase in the allowance for loan losses. The general reserve component of the allowance for loan losses increased $903 thousand and the specific reserve component of the allowance for loan losses increased $833 thousand. The increase in the general reserve was attributable to loan growth and reserves on purchased loans, which were partially offset by improvements to the asset quality and economic conditions qualitative factors. The increase in the specific reserve was attributable to two new impaired loans.

For the prior year ended December 31, 2021, recovery of loan losses of $650 thousand and net charge offs of $1.1 million resulted in a $1.8 million decrease in the allowance for loan losses. The specific reserve component of the allowance for loan losses decreased $2.2 million, while the general reserve component of the allowance for loan losses increased $392 thousand. The decrease in the specific reserve was primarily attributable to the resolution of a previously impaired loan. The increase in the general reserve was attributable to loan growth, an increase in historical losses, and reserves on purchased loans. These increases were partially offset by improvements to the asset quality and economic qualitative factors.

Noninterest Income

Noninterest income increased $2.4 million, or 24%, to $12.6 million for the year ending December 31, 2022, compared to the prior year. The increase was primarily attributable to a $616 thousand, or 30%, increase in service charges on deposit accounts, a $370 thousand, or 13%, increase in ATM and check card fees, a $296 thousand, or 11%, increase in wealth management fees, a $549 thousand, or 99%, increase in other operating income, and a $2.9 million gain on sale of an interest in a company owned by First Bank Financial Services, Inc. The increases in service charges on deposit accounts and ATM and check card fees were attributable to the addition of new customer deposit accounts through the merger with Fincastle during 2021 and an increase in customer check card transactions. Wealth management revenue increased from a higher amount of assets under management. Other operating income increased primarily from a recovery on a purchased loan. These increases were partially offset by a $2.0 million net loss on sale of securities available for sale and a $294 thousand decrease in brokered mortgage fee income.

Noninterest Expense

Noninterest expense increased $2.9 million, or 9%, to $35.6 million for the year ending December 31, 2022, compared to the prior year. Several expense categories increased and were impacted by the addition of employees, customers, branch locations, and a loan production office as a result of the acquisitions of Fincastle and the SmartBank office during the third quarter of 2021. Expense categories that were impacted by the acquisitions included salaries and employee benefits, occupancy, equipment, marketing, ATM and check card expense, FDIC assessment, and other operating expense. The acquisitions impacted the full year of 2022 compared to only a partial year of 2021.

While several expense categories increased, legal and professional fees decreased by $1.1 million and data processing expense decreased by $1.2 million when compared to the prior year. The decreases were attributable to merger and acquisition expenses that were incurred during the prior year ending December 31, 2021. Merger and acquisitions expenses totaled $69 thousand in 2022 compared to $3.5 million in 2021.

Income Taxes

Income tax expense increased $1.4 million during the year ended December 31, 2022 compared to the prior year. 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 year ended December 31, 2022 and 2021. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income and income from bank owned life insurance. A more detailed discussion of the Company's tax calculation is contained in Note 11 to the Consolidated Financial Statements included in this Form 10-K.

Financial Condition

General

Total assets decreased $20.1 million during the year and totaled $1.4 billion at December 31, 2022. The decrease was primarily attributable to a $111.2 million decrease in interest-bearing deposits in banks, which was partially offset by offset by a $93.7 million increase in net loans. Securities available for sale decreased $126.6 million and was mostly offset by securities held to maturity that increased $119.7 million during the year ended December 31, 2022. During 2022, the Bank transferred $74.4 million of market value of securities from the available for sale to the held to maturity category, which contributed to the changes in the securities balances.

Total liabilities decreased $11.4 million during the year and totaled $1.3 billion at December 31, 2022. Total deposits decreased by $7.4 million as savings and interest-bearing deposits decreased by $12.9 million, and time deposits decreased $8.7 million. These decreases were partially offset by a $14.2 million increase in noninterest-bearing demand deposits.

Total shareholders' equity decreased $8.6 million to $108.4 million at December 31, 2022, compared to $117.0 million at December 31, 2021. The decrease was primarily attributable to a $22.8 million decrease in accumulated other comprehensive income due to unrealized losses in the available-for-sale securities portfolio, which was partially offset by a $13.3 million increase in retained earnings. The unrealized loss resulted from market interest rate increases during 2022.

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.

The Bank actively 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 by providing forgivable loans. Loan fees received from the SBA are accreted by the Bank into income evenly over the life of the loans, net of loan origination costs, through interest and fees on loans. PPP loans totaled $350 thousand and $12.4 million at December 31, 2022 and 2021, respectively; with $350 thousand scheduled to mature in the first and second quarters of 2026. The Company believes these loans will ultimately be forgiven and repaid by the SBA in accordance with the terms of the program. 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.

The Bank recognized $359 thousand and $2.0 million of accretion on deferred PPP income, net of origination costs, through interest and fees on loans for year ended December 31, 2022 and 2021, respectively. The total amount of deferred PPP income, net of origination costs, not yet recognized through interest and fees on loans totaled $8 thousand at December 31, 2022.

Loans increased $95.4 million to $920.5 million at December 31, 2022, compared to $825.1 million at December 31, 2021. Residential real estate loans increased by $39.4 million, other real estate loans increased by $53.5 million, and commercial and industrial loans increased by $11.4 million. These increases were partially offset by decreases in construction and land development loans and consumer loans that decreased by $3.9 million and $5.1 million, respectively.

The following table sets forth the maturities of the loan portfolio at December 31, 2022 (in thousands):

Maturity/Repricing Schedule of Loans Held for Investment

December 31, 2022

	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Variable Rate:						
Within 1 year	$ 15,168	$ 12,036	$ 12,611	$ 12,868	$ 77	$ 52,760
1 to 5 years	2,378	13,488	5,195	2,576	152	23,789
5 to 15 years	6,761	113,485	134,740	6,922	3,361	265,269
After 15 years	1,091	46,748	68,853	882	—	117,574
Fixed Rate:						
Within 1 year	16,120	2,440	12,619	5,776	266	37,221
1 to 5 years	6,696	23,385	72,476	39,706	3,538	145,801
5 to 15 years	3,626	75,023	100,016	39,820	187	218,672
After 15 years	—	44,816	11,946	2,675	—	59,437
	$ 51,840	$ 331,421	$ 418,456	$ 111,225	$ 7,581	$ 920,523

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 had $184 thousand and $1.8 million in assets classified as OREO at December 31, 2022 and 2021, respectively.

Non-performing assets totaled $2.9 million and $4.2 million at December 31, 2022 and 2021, representing approximately 0.21% and 0.30% of total assets, respectively. Non-performing assets consisted of $184 thousand of OREO and $2.7 million of non-accrual loans at December 31, 2022. Non-performing assets consisted of $1.8 million of OREO and $2.3 million of non-accrual loans and at December 31, 2021.

At December 31, 2022, 42.8% of non-performing assets were commercial and industrial loans, 18.6% were residential real estate loans, 38.1% construction loans, and 0.5% were other real estate loans. Non-performing assets could increase due to the deterioration of 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 $2.3 million and $1.1 million at December 31, 2022 and December 31, 2021, 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.

There were no loans greater than 90 days past due and still accruing at December 31, 2022 and 2021, respectively.

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. By June 30, 2020, loans participating in the program reached $182.6 million. The majority of these loans resumed regular payments during the second half of 2020 after their deferral periods ended. There were no loans remaining in the program at December 31, 2021. These loans were not considered troubled debt restructurings (TDRs) because they were modified in accordance with relief provisions of the CARES Act and interagency regulatory guidance.

During the fourth quarter of 2020 and the first half of 2021, the Bank modified terms of certain loans for customers that continued to be negatively impacted by the pandemic by lowering borrower's loan payments with interest only payments for periods ranging between 6 and 24 months. Modified loans totaled $9.1 million at December 31, 2022, which were all in the Bank's commercial real estate loan portfolio. All modified loans were either performing under their modified terms or resumed regular loan payments as of December 31, 2022.

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 $7.4 million at December 31, 2022 and $5.7 million at December 31, 2021, representing 0.81% and 0.69% 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, 2022. The allowance for loan losses as a percentage of total loans increased to 0.81% at December 31, 2022 compared to 0.69% at December 31, 2021 primarily as a result of an $833 thousand increase in the specific reserve component of the allowance for loan losses.

For further discussion regarding the allowance for loan losses, see "Provision for Loan Losses" above.

A recovery of loan losses of $66 thousand was recorded in the consumer and other loan class during the year ended December 31, 2022. The recovery of loan losses in the consumer and other loan class resulted primarily from a decrease in the general reserve. This recovery was offset by provision for loan losses totaling $1.9 million in the construction and land development, 1-4 family residential, other real estate loan 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 $2.7 million and $2.3 million at December 31, 2022 and 2021, respectively. The related allowance for loan losses required for these loans totaled $888 thousand and $55 thousand at December 31, 2022 and December 31, 2021, respectively. The average recorded investment in impaired loans during 2022 and 2021 was $1.3 million and $4.5 million, respectively. Included in the impaired loans total are loans classified as TDRs totaling $101 thousand and $1.6 million at December 31, 2022 and 2021, 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, 2022, none of these TDRs were performing under the restructured terms and all were considered non-performing assets.

Management believes, based upon its review and analysis, that the Bank has sufficient reserves to cover losses inherent within the loan portfolio. For each period presented, the provision for 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					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
For the year ended December 31, 2021:						
Balance at beginning of year	$ 306	$ 1,022	$ 4,956	$ 784	$ 417	$ 7,485
Charge-offs	—	(15)	(992)	(6)	(434)	(1,447)
Recoveries	6	65	3	7	241	322
Provision for (recovery of) loan losses	33	5	(737)	(67)	116	(650)
Balance at end of year	$ 345	$ 1,077	$ 3,230	$ 718	$ 340	$ 5,710
Average loans	$ 32,233	$ 265,900	$ 296,381	$ 107,964	$ 10,258	$ 712,736
Ratio of net (recoveries) charge-offs to average loans	-0.02%	-0.02%	0.33%	0.00%	1.88%	0.16%
For the year ended December 31, 2022:						
Balance at beginning of year	345	1,077	3,230	718	340	5,710
Charge-offs	—	—	—	(398)	(131)	(529)
Recoveries	—	10	15	277	113	415
Provision for (recovery of) loan losses	4	192	350	1,370	(66)	1,850
Balance at end of year	$ 349	$ 1,279	$ 3,595	$ 1,967	$ 256	$ 7,446
Average loans	$ 49,671	$ 308,276	$ 399,395	$ 107,561	$ 8,085	$ 872,988
Ratio of net (recoveries) charge-offs to average loans	0.00%	0.00%	0.00%	0.11%	0.22%	0.01%

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,	
	2022	2021
Allocation of Allowance for Loan Losses:		
Real estate loans:		
Construction and land development	$ 546	$ 345
Secured by 1-4 family	1,108	1,077
Other real estate loans	3,609	3,230
Commercial and industrial	1,874	718
Consumer and other loans	309	340
Total allowance for loan losses	$ 7,446	$ 5,710
Ratios of loans to total period-end loans:		
Real estate loans:		
Construction and land development	5.6%	6.8%
Secured by 1-4 family	36.0%	35.4%
Other real estate loans	45.5%	44.2%
Commercial and industrial	12.1%	12.1%
Consumer and other loans	0.8%	1.5%
	100.0%	100.0%

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,	
	2022	2021
Non-accrual loans	$ 2,673	$ 2,304
Other real estate owned	184	1,848
Total non-performing assets	$ 2,857	$ 4,152
Loans past due 90 days accruing interest	—	—
Total non-performing assets and past due loans	$ 2,857	$ 4,152
Troubled debt restructurings	$ 101	$ 1,638
Non-performing assets to period end loans	0.31%	0.50%

The following table summarizes the Company's credit ratios on a consolidated basis as of December 31, 2022 and 2021.

	Consolidated Credit Ratios December 31, 2022	
	2022	2021
Total Loans	$ 920,523	$ 825,118
Nonaccrual loans	$ 2,673	$ 2,304
Allowance for loan losses (ALL)	$ 7,446	$ 5,710
Nonaccrual loans to total loans	0.29%	0.28%
ALL to total loans	0.81%	0.69%
ALL to nonaccrual loans	278.56%	247.83%

Securities

Securities totaled $318.0 million at December 31, 2022, a decrease of $6.8 million, or 2.1%, from $324.8 million at the end of 2021. 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, 2022, 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 $99 thousand and $2.0 million at December 31, 2022 and 2021, respectively. Gross unrealized losses in the available for sale portfolio totaled $24.0 million and $2.6 million at December 31, 2022 and 2021, respectively. There were no gross unrealized gains in the held to maturity portfolio at December 31, 2022. Gross unrealized gains in the held to maturity portfolio totaled $242 thousand at December 31, 2022 Gross unrealized losses in the held to maturity portfolio totaled $11.4 million and $66 thousand at December 31, 2022 and 2021, respectively. Investments in an unrealized loss position were considered temporarily impaired at December 31, 2022 and 2021. The change in the unrealized gains and losses of investment securities from December 31, 2021 to December 31, 2022 was related to changes in market interest rates and was not related to credit concerns of the issuers.

On September 1, 2022, the Bank transferred 24 securities designated as available for sale with a combined book value of $82.2 million, market value of $74.4 million, and unrealized loss of $7.8 million, to securities designated held to maturity. The unrealized loss is being amortized monthly over the life of the securities with an increase to the carrying value of securities and a decrease to the related accumulated other comprehensive loss, which is included in the shareholders' equity section of the Company's balance sheet. The amortization of the unrealized loss on the transferred securities totaled $593 thousand, or $468 thousand net of tax, for the year ended December 31, 2022. The securities selected for transfer had larger potential decreases in their fair market values in higher interest rate environments than most of the other securities in the available for sale portfolio and included U.S. Treasury, agency, municipal and commercial mortgage-backed securities. The securities were transferred to mitigate the potential unfavorable impact that higher market interest rates may have on the carrying value of the securities and on the related accumulated other comprehensive loss. Securities designated as held to maturity are carried on the balance sheet at amortized cost, while securities designated as available for sale are carried at fair market value.

The following table shows the maturities of debt and restricted securities at amortized cost and market value at December 31, 2022 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, 2022

	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years and Equity Securities	Total
U.S. Treasury securities					
Amortized cost	$ —	$ 48,184	$ 2,496	$ —	$ 50,680
Market value	$ —	$ 46,684	$ 2,188	$ —	$ 48,872
Weighted average yield	—%	3.01%	1.28%	—%	2.92%
U.S. agency and mortgage-backed securities					
Amortized cost	$ —	$ 9,566	$ 38,978	$ 160,802	$ 209,346
Market value	$ —	$ 8,845	$ 36,023	$ 142,235	$ 187,103
Weighted average yield	—%	2.22%	2.60%	2.32%	2.37%
Obligations of state and political subdivisions					
Amortized cost	$ 905	$ 6,493	$ 22,516	$ 47,044	$ 76,958
Market value	$ 902	$ 6,409	$ 20,185	$ 38,585	$ 66,081
Weighted average yield	2.67%	3.39%	2.33%	2.49%	2.52%
Corporate debt securities					
Amortized cost	$ —	$ —	$ 3,000	$ —	$ 3,000
Market value	$ —	$ —	$ 2,648	$ —	$ 2,648
Weighted average yield	—%	—%	4.50	—%	4.50%
Restricted securities					
Amortized cost	$ —	$ —	$ —	$ 1,908	$ 1,908
Market value	$ —	$ —	$ —	$ 1,908	$ 1,908
Weighted average yield	—%	—%	—%	4.87%	4.87%
Total portfolio					
Amortized cost	$ 905	$ 64,243	$ 66,990	$ 209,754	$ 341,892
Market value	$ 902	$ 61,938	$ 61,044	$ 182,728	$ 306,612
Weighted average yield (1)	2.67%	2.93%	2.54%	2.38%	2.52%

(1) Yields on tax-exempt securities have been calculated on a tax-equivalent basis using the federal corporate income tax rate of 21 percent. The weighted average yield is calculated based on the relative amortized costs of the securities.

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, 2022, the Company did not own securities of any issuer for which the aggregate book value of the securities of such issuer exceeded ten percent of shareholders' equity.

Deposits

At December 31, 2022, deposits totaled $1.2 billion, decreasing slightly by $7.4 million, from $1.2 billion at December 31, 2021. There was a slight change in the deposit mix when comparing the periods. At December 31, 2022, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 34%, 55%, and 11% of total deposits, respectively, compared to 33%, 55%, and 12% at December 31, 2021.

The following tables include a summary of average deposits and average rates paid (dollars in thousands).

	Average Deposits and Rates Paid Year Ended December 31,			
	2022		2021	
	Amount	Rate	Amount	Rate
Noninterest-bearing deposits	$ 426,823	—%	$ 348,829	—%
Interest-bearing deposits:				
Interest checking	$ 295,530	0.47%	$ 254,077	0.17%
Money market	218,783	0.43%	168,932	0.11%
Savings	205,532	0.08%	164,768	0.07%
Time deposits:				
Less than $100	74,616	0.46%	69,904	0.44%
Greater than $100	62,036	0.69%	52,304	0.74%
Brokered deposits	556	0.57%	650	0.34%
Total interest-bearing deposits	$ 857,053	0.38%	$ 710,635	0.20%
Total deposits	$ 1,283,876		$ 1,059,464	

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

As of December 31, 2022 the estimated amount of total uninsured deposits was $256.5 million. Maturities of the estimated amount of uninsured time deposits at December 31, 2022 are presented in the table below. The estimate of uninsured deposits generally represents the portion of deposit accounts that exceed the FDIC insurance limit of $250,000 and is calculated based on the same methodologies and assumptions used for purposes of the Bank's regulatory reporting requirements.

Maturities of Uninsured Time Deposits

	December 31, 2022
3 months or less	$ 1,730
3-6 months	331
6-12 months	4,207
Over 12 months	4,192
	$ 10,460

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, 2022, cash, interest-bearing and noninterest-bearing deposits with banks, securities, and loans maturing within one year totaled $157.9 million. At December 31, 2022, 10% or $90.0 million of the loan portfolio is scheduled to mature within one year. Non-deposit sources of available funds totaled $287.3 million at December 31, 2022, which included $188.8 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 $47.5 million available through the Federal Reserve Discount Window.

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.

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, 2022 and 2021, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2022	2021
Commitments to extend credit and unfunded commitments under lines of credit	$ 158,297	$ 161,428
Stand-by letters of credit	17,950	18,904

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, 2022, the Bank had $998 thousand 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, 2022, the cash flow hedges had a fair value of $2,679 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, 2022 and December 31, 2021, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

The following table summarizes the Bank's regulatory capital and related ratios at December 31, 2022, and 2021(dollars in thousands).

	Analysis of Capital At December 31,	
	2022	2021
Common equity Tier 1 capital	$ 132,103	$ 120,224
Tier 1 capital	132,103	120,224
Tier 2 capital	7,446	5,710
Total risk-based capital	139,549	125,934
Risk-weighted assets	955,779	852,959
Capital ratios:		
Common equity Tier 1 capital ratio	13.82%	14.09%
Tier 1 capital ratio	13.82%	14.09%
Total capital ratio	14.60%	14.76%
Leverage ratio (Tier 1 capital to average assets)	9.36%	8.82%
Capital conservation buffer ratio(1)	6.60%	6.76%

(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, 2022 and 2021.

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 would not be required to report or calculate risk-based capital. Although the Bank did not opt into the CBLR framework at December 31, 2021, 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 2022, the Board of Directors of the Company authorized a stock repurchase plan pursuant to which the Company could repurchase up to $5.0 million of its outstanding common stock through December 31, 2023. The Company did not repurchase any shares during the year ended December 31, 2022.

The Company continues 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. 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 was able to use the proceeds of the issuance for general corporate purposes. The subordinated debt issued consisted 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. After considering several factors, including the overall risk profile and capital adequacy of the Company and the Bank, on January 1, 2022, the Company repaid $5.0 million of subordinated debt with a fixed interest rate of 6.75% that was issued in 2015. The capital planning process also included consideration of whether to continue the Company's cash dividend payments to common shareholders. The Company continued to pay quarterly cash dividends on its common stock during the years ended December 31, 2022 and 2021.

The Company acquired Fincastle on July 1, 2021 and their shareholders received aggregate merger consideration of $6.8 million in cash and 1,348,065 shares of the Company's common stock. The acquisition of Fincastle resulted in goodwill and other intangible assets that were excluded from the regulatory capital of First Bank. For the twelve-month period ended December 31, 2021, the Company recorded merger and acquisition related expenses of $3.4 million in connection with the acquisition of Fincastle. The Company incurred aggregate Fincastle merger related costs of $3.4 million, which includes $69 thousand of merger related costs incurred during the first and second quarters of 2022.

The Bank acquired SmartBank's Richmond, Virginia office and hired a team of their employees on September 30, 2021, which included the office's loan portfolio and certain fixed assets. The Bank also assumed SmartBank's office lease during the fourth quarter of 2021. The acquisition of the SmartBank loans resulted in goodwill that was excluded from the regulatory capital of the Bank. For the twelve-month period ended December 31, 2021, the Company recorded merger and acquisition related expenses of $101 thousand in connection with the acquisition of the SmartBank loans. The Company did not incur any additional SmartBank acquisition related costs during the year ended December 31, 2022.

First Bank remained well-capitalized at December 31, 2022.

Recent Accounting Pronouncements

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

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 30, 2023

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, 2022. 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, 2022. 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, 2022. 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 2022 end of year consolidated financial statements have been audited by the independent registered public accounting firm of 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 ensure 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 its subsidiary (the Company) as of December 31, 2022 and 2021, the related consolidated statements of income, comprehensive (loss) 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, 2022 and 2021, 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 separate opinions on the critical audit matter or on the accounts or disclosures to which it relates.

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 maintains an allowance for loan losses to provide for probable losses inherent in the loan portfolio. 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, 2022, the general component represented $6.56 million of the total allowance for loan losses of $7.44 million 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. As of December 31, 2022, the qualitative factor adjustments represented $5.64 million of the total allowance for loan losses of $7.44 million.

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:

- Obtaining 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, including evaluating the metrics, the relevance of source data and assumptions.
  - 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 30, 2023

FIRST NATIONAL CORPORATION
Consolidated Balance Sheets
December 31, 2022 and 2021
(in thousands, except share and per share data)

	2022	2021
Assets		
Cash and due from banks	$ 20,784	$ 18,725
Interest-bearing deposits in banks	46,130	157,281
Securities available for sale, at fair value	162,907	289,495
Securities held to maturity, at amortized cost (fair value, 2022, $141,797; 2021, $33,617)	153,158	33,441
Restricted securities, at cost	1,908	1,813
Loans, net of allowance for loan losses, 2022, $7,446, 2021, $5,710	913,077	819,408
Other real estate owned, net of valuation allowance, 2022, $14, 2021, $139	184	1,848
Premises and equipment, net	21,876	22,403
Accrued interest receivable	4,543	3,903
Bank owned life insurance	24,531	24,294
Core deposit intangibles, net	136	154
Goodwill	3,030	3,030
Other assets	17,119	13,642
Total assets	$ 1,369,383	$ 1,389,437
Liabilities & Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 427,344	$ 413,188
Savings and interest-bearing demand deposits	677,139	689,998
Time deposits	136,849	145,566
Total deposits	$ 1,241,332	$ 1,248,752
Subordinated debt	4,995	9,993
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	5,417	4,374
Total liabilities	$ 1,261,023	$ 1,272,398
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, 2022, 6,264,912 shares, 2021, 6,228,176 shares	7,831	7,785
Surplus	32,716	31,966
Retained earnings	90,284	76,990
Accumulated other comprehensive (loss) income, net	(22,471)	298
Total shareholders' equity	$ 108,360	$ 117,039
Total liabilities and shareholders' equity	$ 1,369,383	$ 1,389,437

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Income
Years Ended December 31, 2022 and 2021
(in thousands, except per share data)

	2022	2021
Interest and Dividend Income		
Interest and fees on loans	$ 41,720	$ 32,797
Interest on deposits in banks	1,223	213
Interest on federal funds sold	—	10
Interest and dividends on securities:		
Taxable interest	5,131	3,100
Tax-exempt interest	1,229	936
Dividends	92	88
Total interest and dividend income	$ 49,395	$ 37,144
Interest Expense		
Interest on deposits	$ 3,273	$ 1,415
Interest on subordinated debt	277	619
Interest on junior subordinated debt	270	270
Total interest expense	$ 3,820	$ 2,304
Net interest income	$ 45,575	$ 34,840
Provision for (recovery of) loan losses	1,850	(650)
Net interest income after provision for (recovery of) loan losses	$ 43,725	$ 35,490
Noninterest Income		
Service charges on deposit accounts	$ 2,677	$ 2,061
ATM and check card fees	3,300	2,930
Wealth management fees	3,008	2,712
Fees for other customer services	839	787
Brokered mortgage fees	245	539
Income from bank owned life insurance	597	526
Net (losses) gains on securities available for sale	(2,004)	37
Net gains on sale of loans	—	25
Net (losses) gains on disposal of premises and equipment	(29)	15
Gain on sale of other investment	2,885	—
Other operating income	1,103	555
Total noninterest income	$ 12,621	$ 10,187

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Income
(Continued)
Years Ended December 31, 2022 and 2021
(in thousands, except per share data)

	2022	2021
Noninterest Expense		
Salaries and employee benefits	$ 20,709	$ 17,792
Occupancy	2,218	1,856
Equipment	2,300	1,910
Marketing	813	666
Supplies	528	509
Legal and professional fees	1,414	2,537
ATM and check card expenses	1,370	1,145
FDIC assessment	463	346
Bank franchise tax	930	665
Data processing expense	989	2,156
Amortization expense	19	28
Other real estate (gain) loss and expense, net	(106)	26
Other operating expense	3,950	3,096
Total noninterest expense	$ 35,597	$ 32,732
Income before income taxes	$ 20,749	$ 12,945
Income tax expense	3,952	2,586
Net income	$ 16,797	$ 10,359
Earnings per common share		
Basic	$ 2.69	$ 1.87
Diluted	$ 2.68	$ 1.86

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Comprehensive (Loss) Income
Years Ended December 31, 2022 and 2021
(in thousands)

	2022	2021
Net income	$ 16,797	$ 10,359
Other comprehensive loss, net of tax:		
Unrealized holding (losses) on available for sale securities, net of tax ($5,327) and ($923), respectively	(20,033)	(3,474)
Unrealized holding losses on securities transferred from available for sale to held to maturity, net of tax ($1,638). There were no securities transferred for the year ended December 31, 2021	(6,160)	—
Amortization of unrealized holding losses on available-for-sale securities transferred to held to maturity, net of tax of $125 for the year ended December 31, 2022.	468	—
Reclassification adjustment for losses (gains) included in net income, net of tax $421 and ($8), respectively	1,583	(29)
Change in fair value of cash flow hedges, net of tax $365 and $107, respectively	1,373	403
Total other comprehensive loss	(22,769)	(3,100)
Total comprehensive (loss) income	$ (5,972)	$ 7,259

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
Years Ended December 31, 2022 and 2021
(in thousands)

	2022	2021
Cash Flows from Operating Activities		
Net income	$ 16,797	$ 10,359
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	1,495	1,377
Amortization of core deposit intangibles	18	28
Amortization of debt issuance costs	2	2
Origination of loans held for sale	—	(1,586)
Proceeds from sale of loans held for sale	—	1,856
Net gains on sales of loans held for sale	—	(25)
Provision for (recovery of) loan losses	1,850	(650)
Fair value adjustments on other real estate owned	13	139
Losses (gains) on securities available for sale	2,004	(37)
Net gains on sale of other real estate owned	(176)	(8)
Increase in cash value of bank owned life insurance	(597)	(526)
Accretion of discounts and amortization of premiums on securities, net	1,152	1,078
Accretion of premium on time deposits	(187)	(179)
Accretion of certain acquisition-related discounts, net	(1,130)	(408)
Stock-based compensation	785	354
Excess tax benefits on stock-based compensation	3	3
Losses (gains) on disposal of premises and equipment	29	(15)
Deferred income tax benefit	(241)	(1,682)
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(640)	545
Decrease (increase) in other assets	4,918	(1,714)
Increase (decrease) in accrued interest payable and other liabilities	677	(1,043)
Net cash provided by operating activities	$ 26,772	$ 7,868
Cash Flows from Investing Activities		
Proceeds from maturities, calls, principal payments, and sales of securities available for sale	$ 39,100	$ 54,551
Proceeds from maturities, calls, and principal payments of securities held to maturity	9,239	4,732
Purchases of securities available for sale	(21,147)	(197,074)
Purchases of securities held to maturity	(54,038)	(24,049)
Net (purchase) redemption of restricted securities	(95)	245
Purchase of premises and equipment, net	(1,181)	(835)
Proceeds from sale of premises and equipment	—	32
Proceeds from sale of other real estate owned	2,011	288
Proceeds from cash value of bank owned life insurance	360	—
Net cash paid in acquisition of SmartBank	—	(83,745)
Net cash acquired in acquisition of The Bank of Fincastle	—	39,406
Net (increase) decrease in loans	(94,389)	80,145
Net cash used in investing activities	$ (120,140)	$ (126,304)

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
(Continued)
Years Ended December 31, 2022 and 2021
(in thousands)

	2022	2021
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	$ 1,297	$ 176,387
Net decrease in time deposits	(8,530)	(6,698)
Repayment of subordinated debt	(5,000)	—
Cash dividends paid on common stock, net of reinvestment	(3,308)	(2,505)
Repurchase of common stock, stock incentive plan	(183)	(39)
Repurchase of common stock, stock repurchase plan	—	—
Net cash (used in) provided by financing activities	$ (15,724)	$ 167,145
(Decrease) increase in cash and cash equivalents	$ (109,092)	$ 48,709
Cash and Cash Equivalents		
Beginning	176,006	127,297
Ending	$ 66,914	$ 176,006
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 3,996	$ 2,464
Income taxes	$ 3,365	$ 2,025
Supplemental Disclosures of Noncash Transactions		
Unrealized (losses) on securities available for sale	$ (23,356)	$ (4,434)
Unrealized losses on securities transferred from available for sale to held to maturity	$ (7,205)	$ —
Fair value of securities transferred from available for sale to held to maturity	$ 74,416	$ —
Change in fair value of cash flow hedges	$ 1,738	$ 510
Transfer from premises and equipment to other real estate owned, net	$ (184)	$ —
Lease liabilities arising from obtaining right-of-use assets during the period	$ 491	—
Transfer from loans to other real estate owned	$ —	$ 130
Issuance of common stock, dividend reinvestment plan	$ 194	$ 156
Supplemental Disclosures of Noncash Transactions Related to Acquisitions		
Assets acquired	$ —	$ 306,171
Liabilities assumed	$ —	$ 237,913

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2022 and 2021
(in thousands, except share and per share data)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2020	$ 6,075	$ 6,151	$ 69,292	$ 3,398	$ 84,916
Net income	—	—	10,359	—	10,359
Other comprehensive (loss)	—	—	—	(3,100)	(3,100)
Cash dividends on common stock ($0.48 per share)	—	—	(2,661)	—	(2,661)
Shares issued to shareholders of The Bank of Fincastle, net of costs (1,348,065 shares)	1,685	25,369	—	—	27,054
Stock-based compensation	—	354	—	—	354
Issuance of 7,861 shares common stock, dividend reinvestment plan	9	147	—	—	156
Issuance of 14,073 shares common stock, stock incentive plan	18	(18)	—	—	—
Repurchase of 2,221 shares of common stock, stock incentive plan	(2)	(37)	—	—	(39)
Balance, December 31, 2021	$ 7,785	$ 31,966	$ 76,990	$ 298	$ 117,039

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2021	$ 7,785	$ 31,966	$ 76,990	$ 298	$ 117,039
Net income	—	—	16,797	—	16,797
Other comprehensive (loss)	—	—	—	(22,769)	(22,769)
Cash dividends on common stock ($0.56 per share)	—	—	(3,503)	—	(3,503)
Stock-based compensation	—	785	—	—	785
Issuance of 10,384 shares common stock, dividend reinvestment plan	13	181	—	—	194
Issuance of 34,634 shares common stock, stock incentive plan	43	(43)	—	—	—
Repurchase of 8,283 shares of common stock, stock incentive plan	(10)	(173)	—	—	(183)
Balance, December 31, 2022	$ 7,831	$ 32,716	$ 90,284	$ (22,471)	$ 108,360

See 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). The Company also owns 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 and ESF, LLC which were formed to hold other real estate owned and future office sites. First Bank also owns Bank of Fincastle Services, Inc. which owns an entity that provides mortgage services. The Bank offers loan, deposit, and wealth management products and services in the Shenandoah Valley, central regions of Virginia, Roanoke Valley, 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.

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 require the most subjective or complex judgments relate to the allowance for loan losses, loans acquired in a business combination, and goodwill.

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 Richmond and Roanoke market areas. The types of lending that the Company engages in are included in Note 3. The Company has a concentration of credit risk in commercial real estate, but does not have a significant concentration to any one customer or industry.

Cash and Cash Equivalents

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

Securities

Investments in debt securities with readily determinable fair values are classified as either held to maturity (HTM), available for sale (AFS), or trading based on management's intent. Currently, all of the Company's debt securities are classified as either AFS or HTM. Equity investments in the FHLB, the Federal Reserve Bank of Richmond, and Community Bankers Bank are separately classified as restricted securities and are carried at cost. AFS securities are carried at estimated fair value with the corresponding unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss), and HTM securities are carried at amortized cost. When an individual AFS security is sold, the Company releases the income tax effects associated with the AFS security from accumulated other comprehensive income (loss). 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.

Transfers of debt securities into the held to maturity classification from the available for sale classification are made at fair value on the date of transfer. The unrealized holding gain or loss on the date of the transfer is reported in accumulated other comprehensive loss and in the carrying value of the held to maturity securities. Such amounts are amortized over the remaining contractual lives of the securities. The net impact to income from the amortization and accretion of the unrealized loss at date of transfer is zero.

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

Equity securities with readily determinable fair values are carried at fair value, with changes in fair value reported in net income. Any equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for identical or similar investments. Restricted equity securities are carried at cost and are periodically evaluated for impairment based on the ultimate recovery of par value. The entirety of any impairment on equity securities is recognized in earnings.

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.

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. Interest income includes amortization of purchase premiums and discounts, recognized evenly over the life of the loans.

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.

Loans Acquired in a Business Combination

Acquired loans are classified as either (i) purchased credit-impaired (PCI) loans or (ii) purchased performing loans and are recorded at fair value on the date of acquisition. PCI loans are those for which there is evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. When determining fair value, PCI loans are aggregated into pools of loans based on common risk characteristics as of the date of acquisition such as loan type, date of origination, and evidence of credit quality deterioration such as internal risk grades and past due and nonaccrual status. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the "nonaccretable difference." Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the "accretable yield" and is recognized as interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows. There were no acquired loans classified as PCI in the acquisition of Fincastle and the SmartBank loan portfolio acquisition during the third quarter of 2021.

Purchased performing loans are those for which there is no evidence of credit deterioration and it is probable at the date of acquisition that the Company will collect all contractually required principal and interest payments. When determining fair value, purchased performing loans are evaluated individually on the date of the acquisition. Premiums or discounts recorded on the acquired loans are amortized or accreted into income evenly over the life of the loans through interest and fees on loans. The Company calculates required allowance for loan losses for each of the acquired loans quarterly. Provision for loan losses is recorded for the purchased

performing loans for the amount of the required allowance for loan losses that exceeds any unaccreted discount. All loans acquired from Fincastle and SmartBank in the third quarter of 2021 were considered purchased performing loans.

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 $101 thousand and $1.6 million in loans classified as TDRs as of December 31, 2022 and 2021, respectively.

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.

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.

Goodwill and Other Intangible Assets

Goodwill arises from business combinations and is determined as the excess fair value of the consideration transferred over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exist that indicate that a goodwill impairment test should be performed. The Company has selected June 30 as the date to perform the annual impairment test. Intangible assets with finite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the balance sheet. The Company recorded goodwill as a result of the acquisition of the Bank of Fincastle and SmartBank in 2021.

Other intangible assets consist of core deposit intangible assets arising from whole bank and branch acquisitions and are amortized on an accelerated method over their estimated useful lives, which range from 6 to 10 years.

Derivative Financial Instruments

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, 2022 and 2021. 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.

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 2022 and 2021 was $455 thousand and $487 thousand, respectively.

Comprehensive Income (Loss)

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).

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 Combinations

On July 1, 2021, the Company completed the acquisition of The Bank of Fincastle (Fincastle) for an aggregate purchase price of $33.8 million of cash and stock. On September 30, 2021, the Bank acquired $82.0 million of loans and certain fixed assets from SmartBank related to their Richmond area branch. The Bank purchased the fixed assets for an amount equal to SmartBank's book value. Additional information about these acquisitions is presented in Note 25.

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". The ASU, as amended, requires an entity to measure expected credit losses for financial assets carried at amortized cost based on historical experience, current conditions, and reasonable and supportable forecasts. Among other things, the ASU also amended the impairment model for available for sale securities and addressed purchased financial assets with deterioration. The Company adopted ASU 2016-13 as of January 1, 2023 in accordance with the required implementation date and recorded the impact of adoption to retained earnings of $1.6 million, which was net of deferred income taxes, as required by the standard. The adjustment recorded at adoption consisted of adjustments to the allowance for credit losses on loans and securities held to maturity, as well as an adjustment to the Company's reserve for unfunded loan commitments. Subsequent to adoption, the Company

will record adjustments to its allowances for credit losses and reserves for unfunded commitments through the provision for credit losses in the consolidated statements of income.

The Company is utilizing a third-party model to tabulate its estimate of current expected credit losses, using a discounted cash flow methodology. In accordance with ASC 326, the Company has segmented its loan portfolio based on similar risk characteristics which included commercial and industrial loans, commercial real estate loans, residential real estate loans, and consumer loans. The Company primarily utilizes historical losses from peer companies and economic projections for its reasonable and supportable forecasting of current expected credit losses. To further adjust the allowance for credit losses for expected losses not already included within the quantitative component of the calculation, the Company considers qualitative adjustment factors, which include changes in international, national, regional and local economic factors, changes in the nature and volume of the loan portfolio, changes in the volume and severity of past due loans, and changes in the value of underlying collateral for collateral dependent loans. The Company's CECL implementation process was overseen by the CECL committee and included an assessment of data availability and gap analysis, data collection, consideration and analysis of multiple loss estimation methodologies, an assessment of relevant qualitative factors and correlation analysis of multiple potential loss drivers and their impact on the Company's historical loss experience. During 2022, the Company calculated its current expected credit losses model in parallel to its incurred loss model in order to further refine the methodology and model. In addition, the Company engaged a third-party to perform a comprehensive model validation.

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 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 has identified loans and other financial instruments that are directly or indirectly influenced by LIBOR and plans to modify these financial instruments prior to June 30, 2023. The Company does not expect the modification of the financial instruments to have a material impact on the Company's consolidated financial statements.

In December 2022, the FASB issued ASU 2022-06, "Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848". ASU 2022-06 extends the period of time preparers can utilize the reference rate reform relief guidance in Topic 848. The objective of the guidance in Topic 848 is to provide relief during the temporary transition period, so the FASB included a sunset provision within Topic 848 based on expectations of when the London Interbank Offered Rate (LIBOR) would cease being published. In 2021, the UK Financial Conduct Authority (FCA) delayed the intended cessation date of certain tenors of USD LIBOR to June 30, 2023. To ensure the relief in Topic 848 covers the period of time during which a significant number of modifications may take place, the ASU defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024, after which entities will no longer be permitted to apply the relief in Topic 848. The ASU is effective for all entities upon issuance. The Company is assessing ASU 2022-06 and its impact on the Company's transition away from LIBOR for its loan and other financial instruments.

Note 2. Securities

The Company invests in U.S. Treasury securities, U.S. agency and mortgage-backed securities, obligations of states and political subdivisions, and corporate debt securities. Amortized costs and fair values of securities at December 31, 2022 and 2021 were as follows (in thousands):

	2022			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. Treasury securities	$ 12,469	$ —	$ (1,239)	$ 11,229
U.S. agency and mortgage-backed securities	109,971	95	(13,149)	96,918
Obligations of states and political subdivisions	64,386	4	(9,630)	54,760
Total securities available for sale	$ 186,826	$ 99	$ (24,018)	$ 162,907
Securities held to maturity:				
U.S. Treasury securities	$ 38,211	$ —	$ (568)	$ 37,643
U.S. agency and mortgage-backed securities	99,374	—	(9,189)	90,185
Obligations of states and political subdivisions	12,573	—	(1,252)	11,321
Corporate debt securities	3,000	—	(352)	2,648
Total securities held to maturity	$ 153,158	$ —	$ (11,361)	$ 141,797
Total securities	$ 339,984	$ 99	$ (35,379)	$ 304,704

	2021			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. Treasury securities	$ 39,871	$ 37	$ (250)	$ 39,658
U.S. agency and mortgage-backed securities	177,131	1,085	(1,837)	176,379
Obligations of states and political subdivisions	71,037	910	(509)	71,438
Corporate debt securities	2,019	1	—	2,020
Total securities available for sale	$ 290,058	$ 2,033	$ (2,596)	$ 289,495
Securities held to maturity:				
U.S. agency and mortgage-backed securities	$ 26,392	$ 124	$ (53)	$ 26,463
Obligations of states and political subdivisions	7,049	118	(13)	7,154
Total securities held to maturity	$ 33,441	$ 242	$ (66)	$ 33,617
Total securities	$ 323,499	$ 2,275	$ (2,662)	$ 323,112

At December 31, 2022 and 2021, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	2022					
	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. Treasury securities	$ 9,041	$ (932)	$ 2,188	$ (307)	$ 11,229	$ (1,239)
U.S. agency and mortgage-backed securities	27,282	(1,945)	62,342	(11,204)	89,624	(13,149)
Obligations of states and political subdivisions	24,689	(2,581)	26,362	(7,049)	51,051	(9,630)
Total securities available for sale	$ 61,012	$ (5,458)	$ 90,892	$ (18,560)	$ 151,904	$ (24,018)
Securities held to maturity:						
U.S. Treasury securities	$ 19,302	$ (258)	$ 18,342	$ (310)	$ 37,644	$ (568)
U.S. agency and mortgage-backed securities	58,019	(6,848)	32,167	(2,341)	90,186	(9,189)
Obligations of states and political subdivisions	8,648	(1,008)	2,672	(244)	11,320	(1,252)
Corporate debt securities	2,648	(352)	—	—	2,648	(352)
Total securities held to maturity	$ 88,617	$ (8,466)	$ 53,181	$ (2,895)	$ 141,798	$ (11,361)
Total securities	$ 149,629	$ (13,924)	$ 144,073	$ (21,455)	$ 293,702	$ (35,379)

	2021					
	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. Treasury securities	$ 29,656	$ (250)	$ —	$ —	$ 29,656	$ (250)
U.S. agency and mortgage-backed securities	109,950	(1,335)	14,749	(502)	124,699	(1,837)
Obligations of states and political subdivisions	34,611	(500)	1,009	(9)	35,620	(509)
Total securities available for sale	$ 174,217	$ (2,085)	$ 15,758	$ (511)	$ 189,975	$ (2,596)
Securities held to maturity:						
U.S. agency and mortgage-backed securities	$ 5,411	$ (53)	$ —	$ —	$ 5,411	$ (53)
Obligations of states and political subdivisions	999	(13)	—	—	999	(13)
Total securities held to maturity	$ 6,410	$ (66)	$ —	$ —	$ 6,410	$ (66)
Total securities	$ 180,627	$ (2,151)	$ 15,758	$ (511)	$ 196,385	$ (2,662)

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, 2022, there were 11 out of 11 U.S. Treasury securities, 126 out of 143 U.S. agency and mortgage-backed securities, 107 out of 116 obligations of states and political subdivisions, and one of one corporate debt securities 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 6.5 years at December 31, 2022. At December 31, 2021, there were six out of eight U.S. Treasury securities, 58 out of 135 U.S. agency and mortgage-backed securities and 37 out of 118 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, 2021. The weighted- average re-pricing term of the portfolio was 5.2 years at December 31, 2021. The unrealized losses at December 31, 2022 in the U.S. Treasury securities portfolio, U.S. agency and mortgage-backed securities portfolio, obligations of states and political subdivisions portfolio, and corporate debt securities portfolio were related to changes in market interest rates and not credit concerns of the issuers.

The amortized cost and fair value of securities at December 31, 2022 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	$ —	$ —	$ 905	$ 902
Due after one year through five years	19,801	18,483	44,441	43,455
Due after five years through ten years	39,909	36,498	27,016	24,481
Due after ten years	127,116	107,926	80,796	72,959
	$ 186,826	$ 162,907	$ 153,158	$ 141,797

Proceeds from maturities, calls, principal payments, and sales of securities available for sale during 2022 and 2021 were $39.1 million and $54.6 million, respectively. Gross losses of $2.0 million were realized on calls and sales during 2022 Gross gains of $37 thousand were realized on calls and sales during 2021,

Proceeds from maturities, calls, and principal payments of securities held to maturity during 2022 and 2021 were $9.3 million and $4.7 million, respectively. There were no sales of securities from the held to maturity portfolio for the years ended December 31, 2022 or 2021. The Company did not realize any gross gains or gross losses on held to maturity securities during 2022 or 2021.

Securities having a fair value of $134.5 million and $83.8 million at December 31, 2022 and 2021 were pledged to secure public deposits and for other purposes required by law.

During the third quarter of 2022, management continued to contemplate the accounting treatment of the Company's securities portfolio. Given the rapidly rising interest rates, the resulting effects on capital and to better reflect management's intention to hold certain securities until maturity, management approved the transfer of a portion of the portfolio from the available for sale accounting treatment to the held to maturity accounting treatment. Available for sale securities with a book value of $82.2 million and an associated unrealized loss of $7.8 million were transferred to the held to maturity classification at the fair value of $74.4 million.

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, 2022, and no impairment has been recognized.

The composition of restricted securities at December 31, 2022 and 2021 was as follows (in thousands):

	2022	2021
Federal Home Loan Bank stock	$ 796	$ 701
Federal Reserve Bank stock	980	980
Community Bankers' Bank stock	132	132
	$ 1,908	$ 1,813

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 $599 thousand and $504 thousand at December 31, 2022 and 2021, respectively.

Note 3. Loans

Loans at December 31, 2022 and 2021 are summarized as follows (in thousands):

	2022	2021
Real estate loans:		
Construction and land development	$ 51,840	$ 55,721
Secured by 1-4 family residential	331,421	291,990
Other real estate	418,456	364,921
Commercial and industrial loans	111,225	99,805
Consumer and other loans	7,581	12,681
Total loans	$ 920,523	$ 825,118
Allowance for loan losses	(7,446)	(5,710)
Loans, net	$ 913,077	$ 819,408

Net deferred loan fees included in the above loan categories were $3.2 million and $3.9 million at December 31, 2022 and 2021, respectively. Consumer and other loans included $197 thousand and $175 thousand of demand deposit overdrafts at December 31, 2022 and 2021, respectively.

The following tables provide a summary of loan classes and an aging of past due loans as of December 31, 2022 and 2021 (in thousands):

	December 31, 2022							
	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	$ 115	$ 20	$ 1,045	$ 1,180	$ 50,660	$ 51,840	$ 1,045	$ —
1-4 family residential	1,033	60	207	1,300	330,121	331,421	530	—
Other real estate	109	—	—	109	418,347	418,456	13	—
Commercial and industrial	31	130	1,085	1,246	109,979	111,225	1,085	—
Consumer and other loans	26	25	—	51	7,530	7,581	—	—
Total	$ 1,314	$ 235	$ 2,337	$ 3,886	$916,637	$920,523	$ 2,673	$ —

	December 31, 2021							
	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	$ —	$ 115	$ —	$ 115	$ 55,606	$ 55,721	$ —	$ —
1-4 family residential	1,293	100	372	1,765	290,225	291,990	766	—
Other real estate	186	—	—	186	364,735	364,921	29	—
Commercial and industrial	1,474	—	—	1,474	98,331	99,805	1,509	—
Consumer and other loans	56	11	—	67	12,614	12,681	—	—
Total	$ 3,009	$ 226	$ 372	$ 3,607	$821,511	$825,118	$ 2,304	$ —

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, 2022 and 2021 (in thousands):

	December 31, 2022				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 50,795	$ —	$ 1,045	$ —	$ 51,840
Secured by 1-4 family residential	330,590	—	831	—	331,421
Other real estate	416,559	1,884	13	—	418,456
Commercial and industrial	110,065	75	1,085	—	111,225
Consumer and other loans	7,581	—	—	—	7,581
Total	$ 915,590	$ 1,959	$ 2,974	$ —	$ 920,523

	December 31, 2021				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	$ 55,721	$ —	$ —	$ —	$ 55,721
Secured by 1-4 family residential	290,909	—	1,081	—	291,990
Other real estate	364,892	—	29	—	364,921
Commercial and industrial	97,215	1,081	1,509	—	99,805
Consumer and other loans	12,681	—	—	—	12,681
Total	$ 821,418	$ 1,081	$ 2,619	$ —	$ 825,118

Loans acquired in business combinations are recorded in the Consolidated Balance Sheets at fair value at the acquisition date under the acquisition method of accounting. The outstanding principal balance and the carrying amount at December 31, 2022 and 2021 of loans acquired in business combinations were as follows:

	Acquired Loans - Purchased Performing	
(Dollars in thousands)	2022	2021
Outstanding principal balance	$ 187,017	$ 216,706
Carrying amount		
Real estate loans:		
Construction and land development	$ 9,823	$ 26,348
Secured by 1-4 family residential	42,915	53,803
Other real estate loans	103,521	90,908
Commercial and industrial loans	24,661	36,968
Consumer and other loans	3,560	5,012
Total acquired loans	$ 184,480	$ 213,039

Note 4. Allowance for Loan Losses

The following tables present, as of December 31, 2022 and 2021, the total allowance for loan losses, the allowance by impairment methodology, and loans by impairment methodology (in thousands).

	December 31, 2022					
	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, 2021	$ 345	$ 1,077	$ 3,230	$ 718	$ 340	$ 5,710
Charge-offs	—	(6)	—	(32)	(491)	(529)
Recoveries	10	19	15	145	226	415
Provision for (recovery of) loan losses	191	18	364	1,043	234	1,850
Ending Balance, December 31, 2022	$ 546	$ 1,108	$ 3,609	$ 1,874	$ 309	$ 7,446
Ending Balance:						
Individually evaluated for impairment	—	—	—	888	—	888
Collectively evaluated for impairment	546	1,108	3,609	986	309	6,558
Loans:						
Ending Balance	51,840	331,421	418,456	111,225	7,581	920,523
Individually evaluated for impairment	1,045	530	13	1,085	—	2,673
Collectively evaluated for impairment	50,795	330,891	418,443	110,140	7,581	917,850

	December 31, 2021					
	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, 2020	$ 306	$ 1,022	$ 4,956	$ 784	$ 417	$ 7,485
Charge-offs	—	(15)	(992)	(6)	(434)	(1,447)
Recoveries	6	65	3	7	241	322
Provision for (recovery of) loan losses	33	5	(737)	(67)	116	(650)
Ending Balance, December 31, 2021	$ 345	$ 1,077	$ 3,230	$ 718	$ 340	$ 5,710
Ending Balance:						
Individually evaluated for impairment	—	—	—	55	—	55
Collectively evaluated for impairment	345	1,077	3,230	663	340	5,655
Loans:						
Ending Balance	55,721	291,990	364,921	99,805	12,681	825,118
Individually evaluated for impairment	—	765	30	1,509	—	2,304
Collectively evaluated for impairment	55,721	291,225	364,891	98,296	12,681	822,814

Impaired loans and the related allowance at December 31, 2022 and 2021, were as follows (in thousands):

	December 31, 2022						
	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	$ 2,412	$ 1,045	$ —	$ 1,045	$ —	$ 30	$ 75
Secured by 1-4 family residential	680	530	—	530	—	580	11
Other real estate loans	26	13	—	13	—	22	—
Commercial and industrial	1,084	—	1,085	1,085	888	650	40
Total	$ 4,202	$ 1,588	$ 1,085	$ 2,673	$ 888	$ 1,282	$ 126

	December 31, 2021						
	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	$ —	$ —	$ —	$ —	$ —	$ 91	$ —
Secured by 1-4 family	889	765	—	765	—	429	9
Other real estate loans	40	30	—	30	—	2,384	—
Commercial and industrial	1,673	—	1,509	1,509	55	1,613	—
Total	$ 2,602	$ 795	$ 1,509	$ 2,304	$ 55	$ 4,517	$ 9

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, 2022, loans classified as TDRs and included in impaired loans in the disclosure above totaled $101 thousand. At December 31, 2022, none of the loans classified as TDRs were performing under the restructured terms and all were considered non-performing assets. There were $1.6 million in TDRs at December 31, 2021, 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 no loans modified as TDRs during the year ended December 31, 2022. There was no specific reserve component of the allowance for loan losses relating to the TDRs described above at December 31, 2022. The TDRs described above increased the specific reserve component of the allowance for loan losses by $55 thousand at December 31, 2022.

During the fourth quarter of 2020, the Company 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 that were modified resumed original contractual loan payments during the year ended December 31, 2022.

For the years ended December 31, 2022 and 2021, 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, 2022 and December 31, 2021. Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income in the amount of $177 thousand and $155 thousand during the years ended December 31, 2022 and 2021, respectively.

Note 5. Other Real Estate Owned

Changes in the balance for OREO during the years ended December 31, 2022 and 2021 are as follows (in thousands):

	2022	2021
Balance at the beginning of year, net	$ 1,848	$ —
Transfers in	244	130
Transfers out	(60)	—
Acquired in merger	—	2,137
Sales proceeds	(2,011)	(288)
Gain on disposition	176	8
Balance at the end of year, gross	$ 197	$ 1,987
Less: valuation allowance	(13)	(139)
Balance at the end of year, net	$ 184	$ 1,848

There were no residential real estate properties included in the ending OREO balances at December 31, 2022 and 2021. 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, 2022.

The Company acquired $2.1 million of OREO in the acquisition of Fincastle including $1.8 million of real estate and buildings formerly used as bank premises by Fincastle during the year ended December 31, 2021. The Company did not place these properties into service as bank premises and has designated them as held for sale. Net expenses applicable to OREO, other than the valuation allowance and gain on disposition, were $52 and $34 thousand for the years ended December 31, 2022 and 2021, respectively.

Note 6. Premises and Equipment

Premises and equipment are summarized as follows at December 31, 2022 and 2021 (in thousands):

	2022	2021
Land	$ 5,412	$ 5,486
Buildings and leasehold improvements	20,801	22,158
Furniture and equipment	8,081	8,814
Construction in process	8	—
	$ 34,302	$ 36,458
Less accumulated depreciation	12,426	14,055
Premises and equipment, net	$ 21,876	$ 22,403

Depreciation expense included in operating expenses for 2022 and 2021 was $1.5 million and $1.4 million, respectively.

Note 7. Deposits

The aggregate amount of time deposits, in denominations of $250 thousand or more, was $18.8 million and $19.3 million at December 31, 2022 and 2021, respectively.

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2022 and 2021, brokered deposits totaled $556 thousand and $660 thousand, respectively, and were included in time deposits on the Company's consolidated financial statements.

At December 31, 2022, the scheduled maturities of time deposits were as follows (in thousands):

2023	$	73,486
2024		38,497
2025		12,377
2026		8,063
2027		4,426
Thereafter		—
	$	136,849

Note 8. Other Borrowings

The Company had an unsecured line of credit totaling $5.0 million with a non-affiliated bank at December 31, 2022. There were no borrowings outstanding on the line of credit at December 31, 2022. 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 $287.3 million and $240.4 million available with non-affiliated banks at December 31, 2022 and 2021, respectively. These available sources of credit included $188.8 million available from Federal Home Loan Bank of Atlanta (FHLB), $47.5 million available from the Federal Reserve Bank, and unsecured lines of credit with correspondent banks totaling $51.0 million. The Bank can borrow up to 19% of its total assets through the blanket floating lien agreement with the FHLB. The Bank had collateral pledged on the borrowing line at December 31, 2022 and 2021 including real estate loans totaling $286.6 million and $205.8 million, respectively, and FHLB stock with a book value of $796 thousand and $701 thousand, respectively. The Bank did not have borrowings under these lines of credit at December 31, 2022 and 2021.

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 had a fixed interest rate of 6.75% per annum. Debt issuance costs related to the note were fully amortized at December 31, 2022. The note included a prepayment option beginning January 1, 2021 through the maturity date of October 1, 2025. The Company prepaid the note in full on January 1, 2022 without penalty.

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 $5 and $7 thousand at December 31, 2022 and 2021. 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. The note is an unsecured, subordinated obligation of the Company and it ranks 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 note ranks equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the note. The note ranks senior to all current and future junior subordinated debt obligations, preferred stock, and common stock of the Company. The note is not convertible into common stock or preferred stock, and is not callable by the holder.

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, 2022 and 2021 was 7.34% and 2.82%, 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, 2022 and 2021 was 5.34% and 1.81%, 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.

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 2019.

Net deferred tax assets consisted of the following components at December 31, 2022 and 2021 (in thousands):

	2022	2021
Deferred Tax Assets		
Allowance for loan losses	$ 1,564	$ 1,199
Acquisition accounting adjustments, net	570	822
Post-retirement benefits	188	156
Core deposit intangible	270	309
Unvested stock-based compensation	81	45
Reserve for letter of credit losses	88	66
Limited partnership investments	39	8
Lease liability	113	60
Housing tax credit	—	24
Unrealized loss on securities available for sale	6,536	118
NOL carryover - acquired from Fincastle	1,434	1,548
Loan origination fees, net	176	183
	$ 11,059	$ 4,538
Deferred Tax Liabilities		
Depreciation	$ 701	$ 750
Right of use asset	112	61
Housing equity fund	—	12
Other real estate owned	29	158
Cash flow hedges	563	198
	$ 1,405	$ 1,179
Net deferred tax assets	$ 9,654	$ 3,359

The income tax expense for the years ended December 31, 2022 and 2021 consisted of the following (in thousands):

	2022	2021
Current tax expense	$ 4,193	$ 4,268
Deferred tax benefit	(241)	(1,682)
	$ 3,952	$ 2,586

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, 2022 and 2021, due to the following (in thousands):

	2022	2021
Computed tax expense at statutory federal rate	$ 4,357	$ 2,718
Increase in income taxes resulting from:		
Merger expenses	—	165
Other	8	28
Decrease in income taxes resulting from:		
Tax-exempt interest and dividend income	(252)	(214)
Income from bank owned life insurance	(161)	(111)
	$ 3,952	$ 2,586

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, 2022, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company, without prior regulatory approval, totaled $20.8 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. The Federal Reserve adopted a rule in March 2020 eliminating the reserve requirement. There were no required balances at December 31, 2022 or December 31, 2021

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, 2022 and 2021, expense attributable to the Plan amounted to $1.2 million and $965 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 $151 thousand and $264 thousand for the years ended December 31, 2022 and 2021, respectively, and was solely funded by the Company. The accrued supplemental executive retirement plan liability was $894 thousand and $745 thousand at December 31, 2022 and 2021, respectively.

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, 2022 and 2021 (dollars in thousands, except per share data):

	2022	2021
(Numerator):		
Net income	$ 16,797	$ 10,359
(Denominator):		
Weighted average shares outstanding – basic	6,252,369	5,550,589
Potentially dilutive common shares – restricted stock units	6,988	8,492
Weighted average shares outstanding – diluted	6,259,357	5,559,081
Income per common share		
Basic	$ 2.69	$ 1.87
Diluted	$ 2.68	$ 1.86

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, 2022 and 2021, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2022	2021
Commitments to extend credit and unfunded commitments under lines of credit	$ 158,297	$ 161,428
Stand-by letters of credit	17,950	18,904

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, 2022, the Bank had $998 thousand in locked-rate commitments to originate mortgage loans. There were no loans held for sale at December 31, 2022. 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, 2022 exceeded the insurance limits of the Federal Deposit Insurance Corporation by $1.8 million.

Note 16. Transactions with Related Parties

During the year, executive officers and directors (and their affiliates) 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, 2022 and 2021, these loans totaled $1.1 million and $1.6 million, respectively. During 2022, total principal additions were $11 thousand and total principal payments were $530 thousand.

Deposits from related parties held by the Bank at December 31, 2022 and 2021 amounted to $27.5 million and $17.3 million, respectively.

Note 17. Lease Commitments

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 eight leases, six 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, 2022 and 2021 (in thousands):

	Classification in the Consolidated Balance Sheets	**2022**	**2021**
Operating lease right-of-use asset	Other assets	$ 535	$ 290
Operating lease liability	Accrued interest payable and other liabilities	537	284

The following table presents the weighted average remaining operating lease term and the weighted average discount rate for operating leases as of December 31, 2022 and 2021:

	2022	**2021**
Weighted average remaining lease term, in years	2.5	2.8
Weighted average discount rate	3.51%	2.65%

The following table presents the components of operating lease expense and supplemental cash flow information for the years ended December 31, 2022 and 2021 (in thousands):

	2022	2021
Lease Expense		
Operating lease expense	$ 247	$ 154
Short-term lease expense	33	14
Total lease expense (1)	$ 280	$ 168
Cash paid for amounts included in lease liability	$ 249	$ 156
Right of use assets obtained in exchange for operating lease liabilities commencing during the period	$ 491	$ 92

(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, 2022 (in thousands):

Twelve months ending December 31, 2023	$ 239
Twelve months ending December 31, 2024	215
Twelve months ending December 31, 2025	92
Twelve months ending December 31, 2026	13
Twelve months ending December 31, 2027	—
Total undiscounted cash flows	$ 559
Less: discount	(22)
Operating lease liability	$ 537

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 10,384 and 7,861 common shares to the DRIP during the years ended December 31, 2022 and 2021, respectively.

Note 19. Fair Value Measurements

Determination of Fair Value

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

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

Fair Value Hierarchy

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

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

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, 2022 and 2021 (in thousands).

		Fair Value Measurements at December 31, 2022		
Description	Balance as of December 31, 2022	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. Treasury securities	$ 11,229	$ —	$ 11,229	$ —
U.S. agency and mortgage-backed securities	96,918	—	96,918	—
Obligations of states and political subdivisions	54,760	—	54,760	—
Corporate debt securities	—	—	—	—
Total securities available for sale	$ 162,907	$ —	$ 162,907	$ —
Derivatives - cash flow hedges	2,679	—	2,679	—
Total assets	$ 165,586	$ —	$ 165,586	$ —

Description	Balance as of December 31, 2021	Fair Value Measurements at December 31, 2021 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. Treasury securities	$ 39,658	$ —	$ 39,658	$ —
U.S. agency and mortgage-backed securities	176,379	—	176,379	—
Obligations of states and political subdivisions	71,438	—	71,438	—
Corporate debt securities	2,020	—	2,020	—
Total securities available for sale	$ 289,495	$ —	$ 289,495	$ —
Derivatives - cash flow hedges	941	—	941	—
Total assets	$ 290,436	$ —	$ 290,436	$ —

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, 2022 and 2021.

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.

The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis as of December 31, 2022 and 2021 (dollars in thousands).

		Fair Value Measurements at December 31, 2022		
Description	Balance as of December 31, 2022	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Other real estate owned	$ 184	$ —	$ —	$ 184
Impaired loans, net	$ 197	$ —	$ —	$ 197

		Fair Value Measurements at December 31, 2021		
Description	Balance as of December 31, 2021	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs(Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	$ 1,454	$ —	$ —	$ 1,454

	Quantitative information about Level 3 Fair Value Measurements for December 31, 2022			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (1)
Other real estate owned	$ 184	Property appraisals	Selling cost	10.00%
Impaired loans, net	197	Present value of cash flows	Discount rate	6.50%

	Quantitative information about Level 3 Fair Value Measurements for December 31, 2021			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (1)
Impaired loans, net	$ 1,454	Present value of cash flows	Discount rate	6.50%

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

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, 2022 and 2021 are as follows (in thousands):

		Fair Value Measurements at December 31, 2022 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	$ 66,914	$ 66,914	$ —	$ —	$ 66,914
Securities available for sale	162,907	—	162,907	—	162,907
Securities held to maturity	153,158	—	141,797	—	141,797
Restricted securities	1,908	—	1,908	—	1,908
Loans, net	913,077	—	—	$ 880,473	880,473
Bank owned life insurance	24,531	—	24,531	—	24,531
Accrued interest receivable	4,543	—	4,543	—	4,543
Derivatives - cash flow hedges	2,679	—	2,679	—	2,679
Financial Liabilities					
Deposits	$ 1,241,332	$ —	$ 1,104,483	$ 131,304	$ 1,235,787
Subordinated debt	4,995	—	—	5,267	5,267
Junior subordinated debt	9,279	—	—	6,067	6,067
Accrued interest payable	163	—	163	—	163

		Fair Value Measurements at December 31, 2021 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	$ 176,006	$ 176,006	$ —	$ —	$ 176,006
Securities available for sale	289,495	—	289,495	—	289,495
Securities held to maturity	33,441	—	33,617	—	33,617
Restricted securities	1,813	—	1,813	—	1,813
Loans, net	819,408	—	—	827,248	827,248
Bank owned life insurance	24,294	—	24,294	—	24,294
Accrued interest receivable	3,903	—	3,903	—	3,903
Derivatives - cash flow hedges	941	—	941	—	941
Financial Liabilities					
Deposits	$ 1,248,752	$ —	$ 1,103,186	$ 145,101	$ 1,248,287
Subordinated debt	9,993	—	—	8,932	8,932
Junior subordinated debt	9,279	—	—	8,145	8,145
Accrued interest payable	152	—	152	—	152

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, 2022 and December 31, 2021, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2022, 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, 2022 and December 31, 2021 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, 2022:						
Total Capital (to Risk-Weighted Assets)	$ 139,549	14.60%	$ 76,462	8.00%	$ 95,578	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	$ 132,103	13.82%	$ 57,347	6.00%	$ 76,462	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	$ 132,103	13.82%	$ 43,010	4.50%	$ 62,126	6.50%
Tier 1 Capital (to Average Assets)	$ 132,103	9.36%	$ 55,228	4.00%	$ 69,035	5.00%
December 31, 2021:						
Total Capital (to Risk-Weighted Assets)	$ 125,934	14.76%	$ 68,237	8.00%	$ 85,296	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	$ 120,224	14.09%	$ 51,178	6.00%	$ 68,237	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	$ 120,224	14.09%	$ 38,383	4.50%	$ 55,442	6.50%
Tier 1 Capital (to Average Assets)	$ 120,224	8.82%	$ 54,497	4.00%	$ 68,121	5.00%

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, 2022 and December 31, 2021, 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, 2022 and December 31, 2021, the capital conservation buffer of the Bank was 6.60% and 6.76%, 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, 2020	$ 3,058	$ 340	$ 3,398
Unrealized holding losses (net of tax, ($923))	(3,474)	—	(3,474)
Reclassification adjustment (net of tax, ($8))	(29)	—	(29)
Change in fair value (net of tax, $107)	—	403	403
Change during period	(3,503)	403	(3,100)
Balance at December 31, 2021	$ (445)	$ 743	$ 298
Unrealized holding losses (net of tax, ($5,327))	(20,033)	—	(20,033)
Unrealized holding losses on securities transferred from available for sale to held to maturity (net of tax ($1,513))	(5,692)	—	(5,692)
Reclassification adjustment (net of tax, $421)	1,583	—	1,583
Change in fair value (net of tax, $365)	—	1,373	1,373
Change during period	(24,142)	1,373	(22,769)
Balance at December 31, 2022	$ (24,587)	$ 2,116	$ (22,471)

The following table presents information related to reclassifications from accumulated other comprehensive income (loss) for the years ended December 31, 2022 and 2021 (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,		
	2022	**2021**	
Securities available for sale:			
Net securities losses (gains) reclassified into earnings	$ 2,004	$ (37)	Net (losses) gains on securities available for sale
Related income tax (benefit) expense	(421)	8	Income tax expense
Total reclassifications	$ 1,583	$ (29)	Net of tax

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.

<u>Stock Awards</u>

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 2022, the Company granted and issued 7,500 shares of common stock to members of the Board of Directors for their dedicated service and support. Also during 2022, the Company issued 27,134 shares of common stock to employees. Compensation expense related to stock awards totaled $481 thousand and $127 thousand for the years ended December 31, 2022 and 2021, 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.

On February 9, 2022, 10,110 restricted stock units were granted to employees with 3,375 units vesting immediately, 3,370 units vesting after one year, and 3,365 units vesting after two years. The recipients do 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 recipients become 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:

	2022	
	Shares	Weighted Average Grant Date Fair Value
Unvested, January 1, 2022	30,781	$ 19.79
Granted	10,110	22.19
Vested	(11,643)	20.58
Forfeited	(67)	—
Unvested, December 31, 2022	29,181	$ 20.31

At December 31, 2022, 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 $310 thousand. This expense is expected to be recognized through 2026. Compensation expense related to restricted stock unit awards recognized for the years ended December 31, 2022 and 2021 totaled $304 thousand and $226 thousand, respectively.

Note 23. Revenue Recognition

Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of ASC topic 606. 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. Certain other in-scope revenue, such as gains on OREO are recorded in non-interest expense. 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.

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.

Brokered mortgage fees

Brokered mortgage fees are comprised of loan fee income earned from generating loans in the secondary market. Brokered mortgage fee income is recognized at loan closing.

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.

Gains and losses are recorded when control of the property transfers to the buyer, which generally occurs at the time of transfer of the deed. If the Company finances the sale of a foreclosed property to the buyer, we assess whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the foreclosed property is derecognized and the gain or loss on sale is recorded upon transfer of control of the property to the buyer. For the years ended December 31, 2022 and 2021 net gains/(losses) on sales of foreclosed properties was $176 and $8, respectively.

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, 2022 and 2021 (in thousands):

	2022	2021
Noninterest Income		
Service charges on deposit accounts	$ 2,677	$ 2,061
ATM and check card fees	3,300	2,930
Wealth management fees	3,008	2,712
Brokered mortgage fees	245	539
Fees for other customer services	839	777
Noninterest income (in-scope of Topic 606)	$ 10,069	$ 9,019
Noninterest income (out-of-scope of Topic 606)	2,552	1,168
Total noninterest income	$ 12,621	$ 10,187

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, 2022, 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, 2022 and 2021 (in thousands):

	2022			
	Notional Amount	Assets	Liabilities	Collateral Pledged(1)
Cash Flow Hedges				
Interest rate swap contracts	$ 9,000	$ 2,679	$ —	$ —

	2021			
	Notional Amount	Assets	Liabilities	Collateral Pledged(1)
Cash Flow Hedges				
Interest rate swap contracts	$ 9,000	$ 941	$ —	$ —

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

Note 25. Acquisitions

Acquisition of the Bank of Fincastle

On July 1, 2021, the Company completed its acquisition of Fincastle for an aggregate purchase price of $33.8 million of cash and stock. The Company paid cash consideration of $6.8 million and issued 1,348,065 shares of its common stock to the shareholders of Fincastle.

Upon completion of the transaction, Fincastle was merged with and into the Bank. At the time of closing of the acquisition, Fincastle had six retail bank offices operating in the greater Roanoke region of Virginia. The former Fincastle branches continued to operate as The Bank of Fincastle, a division of First Bank, until the systems were converted on October 16, 2021. As of June 30, 2021, Fincastle reported total assets of $267.9 million, total loans of $194.5 million and total deposits of $236.3 million. For the year ended December 31, 2021, the Company recorded merger related expenses of $3.4 million in connection with the acquisition of Fincastle. The Company estimates that it incurred aggregate costs related to the merger of $3.4 million, with $69 thousand of merger related expenses recorded in the first and second quarters of 2022.

Acquisition of SmartBank Loan Portfolio

On September 30, 2021, the Bank acquired $82.0 million of loans and certain fixed assets from SmartBank related to its Richmond area branch, located in Glen Allen, Virginia. the Bank paid cash consideration of $83.7 million for the loans and fixed assets. Additionally, an experienced team of bankers based out of the SmartBank location have transitioned to become employees of the Bank. The Bank did not assume any deposit liabilities from SmartBank in connection with the transaction, and SmartBank closed their branch operation on December 31, 2021. The Bank assumed the facility lease at the branch on December 31, 2021 and now operates a loan production office in the location of the former SmartBank branch. The Bank's assumption of the lease and acquisition of the remaining branch assets was completed in the fourth quarter of 2021. The Company incurred $101 thousand of expenses related to the acquisition of loans and fixed assets during 2021. There were no acquisition related expenses relating to Smartbank during 2022.

The acquisitions were accounted for as business combinations 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. Determining the fair value of assets and liabilities, particularly related to the loan portfolio, is inherently subjective and involves significant judgment regarding the methods and assumptions used to estimate fair value. During the measurement period, the acquirer shall adjust the amounts recognized at the acquisition date and may recognize additional assets or liabilities to reflect new information obtained from facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. Measurement period adjustments are recognized in the reporting period in which they are determined. The measurement period may not exceed one year from the acquisition date.

The following table presents the total consideration paid by the Company in connection with the acquisition of Fincastle and the SmartBank loan portfolio, the fair values of the assets acquired and liabilities assumed, and the resulting goodwill. Amounts for the Fincastle acquisition are as of July 1, 2021. Amounts for SmartBank are as of September 30, 2021.

(Dollars in thousands)	Bank of Fincastle	SmartBank	Total
Purchase price:			
Cash paid	$ 6,752	$ 83,745	$ 90,497
Common stock issued	27,069	-	27,069
Total purchase price	$ 33,821	$ 83,745	$ 117,566
Identifiable assets acquired:			
Cash and due from banks	$ 46,158	$ -	$ 46,158
Federal funds sold	120	-	120
Securities, AFS, at fair value	12,112	-	12,112
Restricted securities	183	-	183
Loans, net of ALLL	194,617	81,637	276,254
Bank premises and equipment	3,471	172	3,643
Accrued interest receivable	1,588	143	1,731
OREO	2,137	-	2,137
BOLI	5,852	-	5,852
Other assets	4,259	-	4,259
Total identifiable assets acquired	$ 270,497	$ 81,952	$ 352,449
Identifiable liabilities assumed:			
Demand deposits & savings accounts	$ 184,535	$ -	$ 184,535
Time deposits	52,246	-	52,246
Accrued expenses and other liabilities	1,132	-	1,132
Total identifiable liabilities assumed	$ 237,913	$ -	$ 237,913
Net identifiable assets acquired at fair value	$ 32,584	$ 81,952	$ 114,536
Goodwill resulting from acquisitions	$ 1,237	$ 1,793	$ 3,030

The following table presents certain unaudited pro forma information as if the acquisition had taken place on January 1, 2020. These results combine the historical results of Fincastle and the Company for the period prior to the merger. While certain adjustments were made for estimated effects resulting from the application of the acquisition method, including certain fair value adjustments, this pro forma information is not indicative of what would have occurred had the acquisition actually taken place on January 1, 2020. Pro forma adjustments for the year ended December 31, 2021 and December 31, 2020 include the net impact of accretion of loan discounts related to market interest rates, amortization of premiums on deposits, amortization of intangible assets and related income taxes. Unaudited pro forma net income for the years ended December 31, 2021 and 2020 includes after tax merger related expenses of $3.4 million, or ($0.61) per share. These amounts include $629 thousand recorded by Fincastle prior to the merger, which was primarily related to fees paid for legal and financial advisors. Unaudited pro forma net income also includes provision for loan losses recorded by Fincastle for loans that were recorded by the Corporation at fair value upon acquisition and have no allowance for loan losses in the books of the Corporation. Additionally, the Company expects to achieve further operational cost savings and other efficiencies as a result of the acquisition which are not reflected in the unaudited pro forma amounts below.

(Dollars in thousands, except per share amounts)	Unaudited Pro Forma Twelve Months Ended December 31, 2021	Unaudited Pro Forma Twelve Months Ended December 31, 2020
Total revenues (net interest income plus noninterest income)	$ 42,116	$ 43,234
Net income	$ 9,826	$ 7,660
Net income per share, basic	$ 1.77	$ 1.57
Net income per share, diluted	$ 1.77	$ 1.57

The revenue and earnings amounts specific to SmartBank since the acquisition date that are included in the consolidated results for 2021 and 2020 are not readily determinable. The disclosures of these amounts are impracticable due to the merging of certain processes and systems at the acquisition date. Merger related expenses associated with the acquisition of Fincastle and SmartBank combined totaled $3.5 million through December 31, 2021. These costs included the integration of systems and operations and legal and consulting expenses, which have been expensed as incurred. Additional merger related expenses of $69 thousand were incurred throughout the first and second quarters of 2022.

Note 27. Parent Company Only Financial Statements

FIRST NATIONAL CORPORATION
(Parent Company Only)
Balance Sheets
December 31, 2022 and 2021
(in thousands)

	2022	2021
Assets		
Cash	$ 9,501	$ 7,303
Investment in subsidiaries, at cost, plus undistributed net income	110,682	122,964
Other assets	3,024	6,256
Total assets	$ 123,207	$ 136,523
Liabilities and Shareholders' Equity		
Subordinated debt	$ 4,995	$ 9,993
Junior subordinated debt	9,279	9,279
Other liabilities	573	212
Total liabilities	$ 14,847	$ 19,484
Preferred stock	$ —	$ —
Common stock	7,831	7,785
Surplus	32,716	31,966
Retained earnings	90,284	76,990
Accumulated other comprehensive (loss) income, net	(22,471)	298
Total shareholders' equity	$ 108,360	$ 117,039
Total liabilities and shareholders' equity	$ 123,207	$ 136,523

FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Income
Years Ended December 31, 2022 and 2021
(in thousands)

	2022	2021
Income		
Dividends from subsidiary	$ 6,000	$ 6,000
Total income	$ 6,000	$ 6,000
Expense		
Interest expense	$ 547	$ 889
Supplies	5	56
Legal and professional fees	209	107
Data processing	47	29
Management fee-subsidiary	469	305
Other expense	70	104
Total expense	$ 1,347	$ 1,490
Income before allocated tax benefits and undistributed income of subsidiary	$ 4,653	$ 4,510
Allocated income tax benefit	283	312
Income before equity in undistributed income of subsidiary	$ 4,936	$ 4,822
Equity in undistributed income of subsidiary	11,861	5,537
Net income	$ 16,797	$ 10,359

FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2022 and 2021
(in thousands)

	2022	2021
Cash Flows from Operating Activities		
Net income	$ 16,797	$ 10,359
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of subsidiary	(11,861)	(5,537)
Stock-based compensation	785	354
Amortization of debt issuance costs	2	2
Decreae (increase) in other assets	4,969	(5,020)
(Decrease) increase in other liabilities	(3)	1
Net cash provided by operating activities	$ 10,689	$ 159
Cash Flows from Investing Activities		
Net cash paid in acquisition of The Bank of Fincastle	$ —	$ (6,752)
Net cash used in investing activities	$ —	$ (6,752)
Cash Flows from Financing Activities		
Redemption of subordinated debt, net of issuance costs	$ (5,000)	$ —
Cash dividends paid on common stock, net of reinvestment	(3,308)	(2,505)
Repurchase of common stock	(183)	(39)
Net cash (used in) financing activities	$ (8,491)	$ (2,544)
Increase (decrease) in cash and cash equivalents	$ 2,198	$ (9,137)
Cash and Cash Equivalents		
Beginning	7,303	16,440
Ending	$ 9,501	$ 7,303

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, 2022 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.

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, 2022 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

None.

Item 9C. Disclosure Regarding Foreign Jurisdictions that Prevent Inspections

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,” “Delinquent Section 16(a) Reports,” “Code of Conduct and Ethics,” “Committees” and “Director Selection Process” in the Company’s Proxy Statement for the 2023 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 Accountant 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 Service” in the Proxy Statement, which information is incorporated herein by reference.

The Independent Registered Public Accounting Firm for the financial statements as of December 31, 2022 and for the two years then ended was Yount, Hyde & Barbour, P.C., (U.S. PCAOB Auditor Firm I.D.: 613), located in Winchester, Virginia.

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 amended October 12, 2022), attached as Exhibit 3.1 to the Current Report on Form 8-K filed October 26, 2022 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, 2022 formatted in Inline eXtensible Business Reporting Language (iXBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (Loss), (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, 2022, 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.

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 30, 2023

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.

/s/ Scott C. Harvard — Date: March 30, 2023
President & Chief Executive Officer Director
(principal executive officer)

/s/ M. Shane Bell — Date: March 30, 2023
Executive Vice President & Chief Financial Officer
(principal financial officer and principal accounting officer)

/s/ Elizabeth H. Cottrell — Date: March 30, 2023
Chairman of the Board of Directors

/s/ Gerald F. Smith, Jr. — Date: March 30, 2023
Vice Chairman of the Board of Directors

/s/ Jason C. Aikens — Date: March 30, 2023
Director

/s/ Emily Marlow Beck — Date: March 30, 2023
Director

/s/ Boyce E. Brannock — Date: March 30, 2023
Director

/s/ W. Michael Funk — Date: March 30, 2023
Director

/s/ James R. Wilkins, III — Date: March 30, 2023
Director

/s/ Kirtesh Patel — Date: March 30, 2023
Director

/s/ George E. Holt, III — Date: March 30, 2023
Director

______________________ Date: ______________________
Director

Exhibit 21.1

Subsidiaries of First National Corporation

Name of Subsidiary	State of Organization
First Bank, Inc.	Virginia
- First Bank Financial Services, Inc.	Virginia
- Shen-Valley Land Holdings, LLC	Virginia
- Bank of Fincastle Financial Service, Inc.	Virginia
- ESF, LLC	Virginia
First National (VA) Statutory Trust II	Delaware
First National (VA) Statutory Trust III	Delaware

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statements on Form S-3 (No. 333-261751), Form S-3D (No. 333-34148) and Form S-8 (No. 333-202022) of First National Corporation of our report dated March 30, 2023, relating to our audit of the consolidated financial statements appearing in this Annual Report on Form 10-K of First National Corporation for the year ended December 31, 2022.

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

Winchester, Virginia
March 30, 2023

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
SECTION 302 CERTIFICATION

I, Scott C. Harvard, certify that:

1. I have reviewed this annual report on Form 10-K of First National Corporation for the year ended December 31, 2022;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)), for the registrant and have:

    a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

    c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

    a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Scott C. Harvard
President and Chief Executive Officer

Date: March 30, 2023

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
SECTION 302 CERTIFICATION

I, M. Shane Bell, certify that:

1. I have reviewed this annual report on Form 10-K of First National Corporation for the year ended December 31, 2022;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)), for the registrant and have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

/s/ M. Shane Bell
Executive Vice President and Chief Financial Officer

Date: March 30, 2023

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Annual Report on Form 10-K of First National Corporation for the year ended December 31, 2022, I, Scott C. Harvard, President and Chief Executive Officer of First National Corporation, hereby certify pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-K for the year ended December 31, 2022, fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-K for the year ended December 31, 2022, fairly presents, in all material respects, the financial condition and results of operations of First National Corporation.

Date: March 30, 2023

/s/ Scott C. Harvard
President and Chief Executive Officer

Exhibit 32.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Annual Report on Form 10-K of First National Corporation for the year ended December 31, 2022, I, M. Shane Bell, Executive Vice President and Chief Financial Officer of First National Corporation, hereby certify pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-K for the year ended December 31, 2022, fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-K for the year ended December 31, 2022, fairly presents, in all material respects, the financial condition and results of operations of First National Corporation.

/s/ M. Shane Bell
Executive Vice President and Chief Financial Officer

Date: March 30, 2023

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