

2023 ANNUAL REPORT & FORM 10-K





March 29, 2024

Dear Shareholders:

The year 2023 was another challenging year for the banking industry thanks in large part to the Federal Reserve's continued efforts to combat inflation, which has proven to be anything but "transitory." During the year, the U.S. Treasury yield curve remained inverted with short-term rates much higher than longer term rates. For the banking business, the inversion of the yield curve makes managing the net interest margin very difficult. Compounding that structural challenge was four consecutive rate increases from the Federal Open Market Committee, driving up the cost of funds for banks dramatically over the course of the year.

I was proud of how First National Corporation and our subsidiary, First Bank, navigated the environment. We were able to keep the cost of deposits under control compared to some of our peers, while also growing the loan portfolio at rates high enough to begin to offset the increased cost of deposits. The result was a decline of net interest income of about \$2.2 million and a net interest margin for the year of 3.41% compared to 3.44% for the prior year.

While our banking team performed admirably throughout the year, we were disappointed with the discovery in the fourth quarter of weaknesses in a purchased loan portfolio that required substantial charge offs and provisions for credit losses. Provisions for the year totaled over \$6 million and undermined what otherwise would have been a very profitable year. Instead, net income totaled \$9.6 million and diluted earnings per common share was \$1.53 for the year ended December 31, 2023. This compared to net income of \$16.8 million and diluted earnings per common share of \$2.68 for the year ended December 31, 2022.

During the year, we continued to make investments for the future, including expanding our leadership team and presence in the Roanoke market, upgrading core technology and the services attached thereto, and bolstering our senior level management.

We were also pleased to announce the signing of a definitive merger agreement on March 25, 2024, whereby Touchstone Bankshares, Inc. would be merged with and into First National Corporation and Touchstone Bank would be merged with and into First Bank. We believe combining our two companies will create one of the most attractive community bank franchises in Virginia, and if the transaction is well executed and well-integrated, should provide significant value to our shareholders in the future.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott C. Harvard", with a stylized, looping flourish at the end.

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, 2023

or

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

For the transition period from _____ to _____
Commission file number 1-38874



(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

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

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

22657
(Zip Code)

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

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

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

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this Chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

Smaller reporting company ☒

Emerging growth company ☐

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

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

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, 2023 was \$85,479,214.

The number of outstanding shares of common stock as of March 19, 2024 was 6,277,373.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for the 2024 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 credit 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 credit losses on loans;
- 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;
- changes in accounting principles, policies and guidelines and elections made by the Company thereunder;
- cyber threats, attacks or events;
- the ability to maintain adequate liquidity by retaining deposit customers and secondary funding sources, especially if the Company’s, 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 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.

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.

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, 2023, the Bank was ranked third overall in its market area with 11.13% 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, 2023, the Bank employed a total of 224 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, 2023 and December 31, 2022, 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, 2023:

	First Bank
Total capital to risk-weighted assets	14.05%
Tier 1 capital to risk-weighted assets	12.82%
Common equity Tier 1 capital to risk-weighted assets	12.82%
Tier 1 capital to average assets	9.31%
Capital conservation buffer ratio(1)	6.05%

- (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, 2023 and December 31, 2022.

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 that increased base deposit insurance assessment rate schedules uniformly by 2 basis points beginning in the first quarterly assessment period of 2023. The increase was 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, 2023.

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 October 2023, federal bank regulatory agencies jointly issued a final rule intended to strengthen and modernize the CRA regulatory framework. Most of the final rule's new requirements are applicable beginning January 1, 2026. The remaining new requirements, including data reporting requirements, are applicable on January 1, 2027. The rule is intended to, 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, 2023, 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 created the Small Business Administration (SBA) 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 on 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 credit losses on loans may prove to be insufficient to absorb losses in its loan and securities portfolios.

Like all financial institutions, the Company maintains an allowance for credit losses (ACL) to provide for loans and securities that may not repay in their entirety. The Company believes that it maintains an ACL at a level adequate to absorb expected losses inherent in the loan and securities portfolios as of the corresponding balance sheet date and in compliance with applicable accounting and regulatory guidance. However, the ACL may not be sufficient to cover actual losses and future provisions for credit losses could materially and adversely affect the Company's operating results. Accounting measurements related to impairment and the allowance for credit 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 or security. 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 credit loss provisions due to the uncertain economic conditions.

The Company's banking regulators, as an integral part of their examination process, periodically review the ACL and may require the Company to increase its allowance for credit losses by recognizing additional provisions for credit losses charged to expense, or to decrease the allowance for credit losses on loans by recognizing loan charge-offs, net of recoveries. Any such required additional provisions for credit 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 credit 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 credit 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 has purchased certain loans through third-party lending programs. 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.

Prepayments of loans and securities could materially impact earnings through a reduction in interest income and fees on loans and interest income on securities.

The Company assumes earnings risk from the potential prepayment of loans and securities purchased at premiums. The Company's loan portfolio includes commercial and industrial loans purchased at premiums through third-party lending programs as well as loans acquired through business combinations, which resulted in purchase premiums. Additionally, the Company purchases securities at premiums from time-to-time for its investment portfolio. Premiums on performing loans are amortized over the life of the loans and premiums on securities are amortized to the earlier of their call dates or maturity dates. Prepayments of the loans and securities would accelerate amortization expense of unamortized premiums and could result in a material decrease in earnings during future periods from a reduction of interest income and fees on loans or interest income on securities.

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 and 2023, 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.

Risks Related to our Industry

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 and 2023, 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.

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 and our vendors' 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, including those of our vendors, 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 those of our vendors, 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.

In addition, financial challenges at other banking institutions could lead to depositor concerns that spread within the banking industry. In March 2023, Silicon Valley Bank and Signature Bank experienced large deposit outflows coupled with insufficient liquidity to meet withdrawal demands, resulting in the institutions being placed into FDIC receiverships. In the aftermath, there was substantial market disruption and concern that diminished depositor confidence could spread across the banking industry, leading to deposit outflows that could destabilize other institutions. While public confidence in the banking system has stabilized, deposit outflows caused by reputational concerns or events affecting the banking industry generally could adversely affect the Company's liquidity, financial condition, and 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.

The CFPB has recently pursued a more aggressive enforcement policy with respect to a range of regulatory compliance matters, specifically including fair lending, loan servicing, financial institution sales and marketing practices, and financial institution consumer fee and account management practices. For example, in 2023, the CFPB brought enforcement actions against a number of financial

institutions for overdraft practices that the CFPB alleged to be unlawful and ordered each of these institutions to pay a substantial civil money penalty in addition to customer restitution. Despite our ongoing compliance efforts, we may become subject to regulatory enforcement actions with respect to our programs and practices. The costs and limitations related to this additional regulatory scrutiny with respect to consumer product offerings and services may adversely affect the Company's profitability.

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 more information regarding recent accounting pronouncements and their effects on the Company, 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.

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 1C. Cybersecurity

Risk Management and Strategy

The Company's risk management program is designed to identify, assess, and mitigate risks across various aspects of our Company, including financial, operational, regulatory, reputational, and legal. Cybersecurity is a critical component of this program, given the increasing reliance on technology and potential of cyber threats. The Chief Risk Officer is primarily responsible for this cybersecurity component and is a key member of the risk management organization, reporting directly to the Chief Executive Officer and, as discussed below, periodically to the Audit Committee of the Board of Directors.

The objective for managing cybersecurity risk is to avoid or minimize the impacts of external threat events or other efforts to penetrate, disrupt or misuse our systems or information. The structure of our information security program is designed around the National Institute of Standards and Technology ("NIST") Cybersecurity Framework, regulatory guidance, and other industry standards. In addition, we leverage certain industry and government associations, third-party benchmarking, audits, and threat intelligence feeds to facilitate and promote program effectiveness. The Chief Risk Officer, along with key members of the information security team, regularly collaborates with peer banks, industry groups, and policymakers to discuss cybersecurity trends and issues and identify best practices. The information security program is periodically reviewed by such personnel with the goal of addressing changing threats and conditions.

The Company employs an in-depth, layered, defensive strategy that embraces a "trust by design" philosophy when designing new products, services, and technology. We leverage people, processes, and technology as part of our efforts to manage and maintain cybersecurity controls. We also employ a variety of preventative and detective tools designed to monitor, block, and provide alerts regarding suspicious activity, as well as to report on suspected advanced persistent threats. We have established processes and systems designed to mitigate cyber risk, including regular and on-going education and training for employees, preparedness simulations and tabletop exercises, and recovery and resilience tests. We engage in regular assessments of our infrastructure, software systems, and network architecture, using internal cybersecurity experts and third-party specialists. We also maintain a third-party risk management program designed to identify, assess, and manage risks, including cybersecurity risks, associated with external service providers and our supply chain. We also actively monitor our email gateways for malicious phishing email campaigns and monitor remote connections as a significant portion of our workforce has the option to work remotely. We leverage internal and external auditors and independent external partners to periodically review our processes, systems, and controls, including with respect to our information security program, to assess their design and operating effectiveness and make recommendations to strengthen our risk management program.

We maintain an Incident Response Plan that provides a documented framework for responding to actual or potential cybersecurity incidents, including timely notification of and escalation to the appropriate Board-approved management committees, as discussed further below, and to the Audit Committee of our Board of Directors. The Incident Response Plan is coordinated through the Information Security Officer and key members of management are embedded into the Incident Response Plan by its design. The Incident Response Plan facilitates coordination across multiple parts of our organization and is evaluated at least annually.

Notwithstanding these defensive measures and processes, the threat posed by cyber-attacks is severe. Internal systems, processes, and controls are designed to mitigate loss from cyber-attacks and, while we have experienced cybersecurity incidents in the past, to date, risks from cybersecurity threats have not materially affected our company. For further discussion of risks from cybersecurity threats, see the section captioned "Risks Related to Operations and Technology" in Item 1A. Risk Factors.

Governance

The Chief Risk Officer is accountable for managing our enterprise information security department and delivering our information security program. The responsibilities of this department include cybersecurity risk assessment, defense operations, incident response, vulnerability assessment, threat intelligence, identity access governance, third-party risk management, and business resilience. The foregoing responsibilities are covered on a day-to-day basis by a first line of defense function, and our second line of defense function, including the Information Security Officer, provides guidance, oversight, monitoring and challenge of the first line's activities. The second line of defense function is separated from the first line of defense function through organizational structure and ultimately reports directly to the Chief Risk Officer. The department, as a whole, consists of information security professionals with varying degrees of education and experience. Individuals within the department are generally subject to professional education and certification requirements. In particular, our Chief Risk Officer has substantial relevant expertise and formal training in the areas of information security and cybersecurity risk management.

The Audit Committee of our Board of Directors is responsible for overseeing our information security and technology governance programs, including management's actions to identify, assess, mitigate, and remediate or prevent material cybersecurity issues and risks. Our Chief Risk Officer provides quarterly reports to the Audit Committee of our Board of Directors regarding the information security program and the technology program, key enterprise cybersecurity initiatives, and other matters relating to cybersecurity processes. The Audit Committee of our Board of Directors reviews and approves our information security and technology policies annually. Additionally, the Audit Committee of our Board of Directors reviews our cyber security risk profile on a quarterly basis. The Audit Committee of our Board of Directors provides a report of their activities to the full Board of Directors at each board meeting.

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, 2023, 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 19, 2024 the Company had 802 shareholders of record and approximately 1,143 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 could have repurchased up to \$5.0 million of its outstanding common stock. Repurchases under the plan were made during 2023 through open market transactions 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. The Company repurchased 37,532 shares of common stock under the purchase plan at a weighted average price of \$15.14 during 2023. There were no repurchases of common stock during the fourth quarter of 2023.

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, 2023 and 2022 should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements included in Item 8 of this Form 10-K.

Executive Overview

The Company

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

- First Bank (the Bank). The Bank owns:
 - First Bank Financial Services, Inc.
 - Shen-Valley Land Holdings, LLC
 - 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, and ATM and check card fees.

Primary expense categories are salaries and employee benefits, which comprised 57% of noninterest expenses during 2023, followed by occupancy and equipment expense, which comprised 12% of noninterest expenses. The provision for credit losses is also a primary expense of the Bank. The provision is determined by factors that include net charge-offs, asset quality, loan growth, evaluation of the size and current risk characteristics of the loan portfolio, past events, current conditions, reasonable and supportable forecasts of future economic conditions, and prepayment experience. 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 credit losses.

Overview of Financial Performance and Condition

Net income decreased by \$7.2 million to \$9.6 million, or \$1.53 per diluted share, for the year ended December 31, 2023, compared to \$16.8 million, or \$2.68 per diluted share, for the same period in 2022. Return on average assets was 0.71% and return on average equity was 8.59% for the year ended December 31, 2023, compared to 1.19% and 15.87%, respectively, for the year ended December 31, 2022.

The \$7.2 million decrease in net income resulted from a \$4.3 million, increase in provision for credit losses, a \$2.2 million, or 5%, decrease in net interest income, a \$866 thousand, or 7%, decrease in noninterest income, and a \$1.6 million, or 5%, increase in noninterest expense. These unfavorable variances were partially offset by a \$1.8 million decrease in income tax expense.

Net interest income decreased \$2.2 million, or 5%, from a \$10.5 million increase in total interest expense, which was partially offset by an \$8.3 million increase in total interest income. Net interest income was negatively impacted by a 3-basis point contraction of the net interest margin to 3.41% and a \$51.6 million, or 4%, decrease in average earning assets.

The provision for credit losses increased \$4.3 million, to \$6.2 million in 2023 compared to \$1.9 million in 2022. The allowance for credit losses on loans totaled \$12.0 million, or 1.24% of total loans, at December 31, 2023, compared to \$7.4 million, or 0.81% of total loans, at December 31, 2022. The allowance for credit losses on loans individually evaluated increased \$1.8 million compared to the prior year. The allowance for credit losses on loans collectively evaluated increased \$2.9 million compared to the prior year. Net charge-offs totaled \$3.6 million in 2023 and \$114 thousand in 2022.

Noninterest income totaled \$11.8 million for the year, which was a decrease of \$866 thousand, or 7%, compared to \$12.7 million for the prior year. The decrease was primarily a result of a gain on sale of other investment of \$2.9 million in the prior year, which was partially offset by \$2.0 million of net losses on sale of securities available for sale in the prior year. The gain on sale of other investment in the prior year resulted from a gain on sale of an interest in a broker-dealer of investment securities by First Bank Financial Services, Inc.

Noninterest expense increased \$1.6 million, or 5%, in 2023, compared to the prior year. The increase was attributable to increases in several categories, including salaries and employee benefits, marketing, legal and professional fees, ATM and check card expense, FDIC assessment, bank franchise tax, and other operating expenses.

The following is selected financial data for the Company for the years ended December 31, 2023 and 2022. 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,				
	2023		2022	
Results of Operations				
Interest and dividend income	\$	57,719	\$	49,395
Interest expense		14,306		3,820
Net interest income		43,413		45,575
Provision for credit losses		6,150		1,850
Net interest income after provision for credit losses		37,263		43,725
Noninterest income		11,784		12,621
Noninterest expense		37,242		35,597
Income before income taxes		11,805		20,749
Income tax expense		2,181		3,952
Net income	\$	9,624	\$	16,797
Key Performance Ratios				
Return on average assets		0.71%		1.19%
Return on average equity		8.59%		15.87%
Net interest margin (1)		3.41%		3.44%
Efficiency ratio (1)		67.69%		61.75%
Dividend payout		39.05%		20.85%
Equity to assets		7.97%		7.91%
Per Common Share Data				
Net income, basic	\$	1.54	\$	2.69
Net income, diluted		1.53		2.68
Cash dividends		0.60		0.56
Book value at period end		18.06		16.79
Financial Condition				
Assets	\$	1,419,295	\$	1,369,383
Loans, net		957,456		913,077
Securities		303,179		317,973
Deposits		1,233,726		1,241,332
Shareholders' equity		116,271		108,360
Average shares outstanding, diluted		6,279		6,259
Capital Ratios (2)				
Leverage		9.31%		9.36%
Risk-based capital ratios:				
Common equity Tier 1 capital		12.82%		13.82%
Tier 1 capital		12.82%		13.82%
Total capital		14.05%		14.60%

(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 Credit Losses," "Noninterest Income," "Noninterest Expense" and "Income Taxes" below.

Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO expense, amortization of intangibles, and merger expenses, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding (gains)/losses on disposal of premises and equipment, and 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	
	2023	2022
Noninterest expense	\$ 37,242	\$ 35,597
Subtract: other real estate (gain) loss and expense, net	199	106
Subtract: amortization of intangibles	(18)	(19)
Subtract: merger related expenses	—	(69)
	<u>\$ 37,423</u>	<u>\$ 35,615</u>
Tax-equivalent net interest income	\$ 43,738	\$ 45,906
Noninterest income	11,784	12,621
(Gain) loss on disposal of premises and equipment	(47)	29
Gain on sale of other investment	(186)	(2,885)
Securities losses (gains), net	—	2,004
	<u>\$ 55,289</u>	<u>\$ 57,675</u>
Efficiency ratio	<u>67.69%</u>	<u>61.75%</u>

This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for both 2023 and 2022 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	
	2023	2022
GAAP measures:		
Interest income - loans	\$ 49,293	\$ 41,720
Interest income - investments and other	8,426	7,675
Interest expense - deposits	(13,660)	(3,273)
Interest expense – subordinated debt	(277)	(277)
Interest expense – junior subordinated debt	(271)	(270)
Interest expense - other borrowings	(98)	—
Total net interest income	<u>\$ 43,413</u>	<u>\$ 45,575</u>
Non-GAAP measures:		
Tax benefit realized on non-taxable interest income - loans	\$ —	\$ 5
Tax benefit realized on non-taxable interest income - municipal securities	325	326
Total tax benefit realized on non-taxable interest income	<u>\$ 325</u>	<u>\$ 331</u>
Total tax-equivalent net interest income	<u>\$ 43,738</u>	<u>\$ 45,906</u>

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 Credit Losses on Loans

The allowance for credit losses on loans (ACLL) is established as losses are estimated to have occurred through a provision for credit 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 ACLL, see Notes 1, 3, and 4 to the Consolidated Financial Statements included in this Form 10-K.

The ACLL is evaluated on a quarterly basis by management and is based on a discounted cash flow model to estimate its current expected credit losses. For the purposes of calculating its quantitative reserves, the Company has segmented its loan portfolio based on loans which share similar risk characteristics. Within the quantitative portion of the calculation, the Company utilizes at least one or a combination of loss drivers, which may include unemployment rates, home price indices, and/or gross domestic product ("GDP"), to adjust its loss rates over a reasonable and supportable forecast period of one year. A straight-line reversion technique is used for the following eight quarters, at which time the Company reverts to historical averages. To further adjust the allowance for credit losses for expected losses not already included within the quantitative component of the calculation, the Company may consider qualitative factors, including but not limited to: variability in the economic forecast, changes in volume and severity of adversity classified loans, changes in concentrations of credit, changes in the nature and volume of the loan segments, factors related to credit administration, and other idiosyncratic risks not embedded in the data used in the model. 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 credit losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio.

The allowance for loan credit losses represents an amount which, in management's judgment, is adequate to absorb the lifetime expected losses that may be sustained on outstanding loans at the balance sheet date based on the evaluation of the size and current risk characteristics of the loan portfolio, past events, current conditions, reasonable and supportable forecasts of future economic conditions, and prepayment experience. The allowance for loan credit losses is measured and recorded upon the initial recognition of a financial asset. The allowance for loan credit losses is reduced by charge-offs, net of recoveries of previous losses, and is increased or decreased by a provision for (or recovery of) credit losses, which is recorded in the Consolidated Statement of Income. 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 ACLL consists of loans individually evaluated and loans collectively evaluated. Loans that do not share risk characteristics are evaluated on an individual basis. The Company designates individually evaluated loans on nonaccrual status as collateral dependent loans, as well as other loans that management of the Company designates as having higher risk and loans for which the repayment is expected to be provided substantially through the operation or sale of the collateral. These loans do not share common risk characteristics and are not included within the collectively evaluated loans for determining the allowance for credit losses. Under CECL, for collateral dependent loans, the Company has adopted the practical expedient to measure the allowance for credit losses based on the fair value of collateral. The allowance for credit losses is calculated on an individual loan basis based on the shortfall between the fair value of the loan's collateral, which is adjusted for liquidation costs/discounts, and amortized cost. If the fair value of the collateral exceeds the amortized cost, no allowance is required. For further information regarding the ACLL, see Notes 1 and 4 to the Consolidated Financial Statements included in this Form 10-K.

Allowance for Credit Losses – Held-to-Maturity Securities

The Company estimates expected credit losses on held-to-maturity securities on an individual basis based on a Probability of Default/Loss Given Default ("PD/LGD") methodology primarily using security-level credit ratings. The primary indicators of credit quality for the Company's held-to-maturity portfolio are security type and credit ratings, which are influenced by a number of factors including obligor cash flow, geography, seniority, among other factors. The Company's held-to-maturity securities with credit risk are municipal bonds and corporate debt securities. All other held-to-maturity securities are covered by the explicit or implied guarantee of the United States government or one of its agencies.

Changes in the allowance for credit loss are recorded as provision for (or recovery of) credit losses in the Consolidated Statements of Income. The Company recorded an allowance for credit losses on held-to-maturity securities of \$132 thousand upon adoption of ASC 326.

Allowance for Credit Losses – Available-for-Sale Securities

Management evaluates all available-for-sale securities in an unrealized loss position on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. If the Company has the intent to sell the security or it is more likely than not that the Company will be required to sell the security, the security is written down to fair value and the entire loss is recorded in earnings.

If either of the above criteria is not met, the Company evaluates whether the decline in fair value is the result of credit losses or other factors. In making the assessment, the Company may consider various factors including the extent to which fair value is less than amortized cost, downgrades in the ratings of the security by a rating agency, the failure of the issuer to make scheduled interest or principal payments and adverse conditions specific to the security. If the assessment indicates that a credit loss exists, the present value of cash flows expected to be collected are compared to the amortized cost basis of the security and any deficiency is recorded as an allowance for credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any amount of unrealized loss that has not been recorded through an allowance for credit loss is recognized in other comprehensive income.

Changes in the allowance for credit loss are recorded as a provision for (or recovery of) credit losses in the Consolidated Statements of Income. Losses are charged against the allowance for credit loss when management believes an available-for-sale security is confirmed to be uncollectible or when either of the criteria regarding intent or requirement to sell is met.

Allowance for Credit Losses – Unfunded Commitments

Financial Instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit issued to meet customer financing needs. The Company's exposure to credit losses in the event of nonperformance by the other party to the financial instrument for off-balance sheet loan commitments is represented by the contractual amount of those instruments. Such financial instruments are recorded when they are funded.

The Company records all allowance for credit losses on off-balance sheet credit exposures, unless the commitments to extend credit are unconditionally cancelable, through a charge to provision for (or recovery of) credit losses in the Consolidated Statement of

Income. The allowances for credit losses on off-balance sheet credit exposures is estimated by loan segment at each balance sheet date under the current expected credit losses model using the same methodology as the loan portfolio, taking into consideration the likelihood that funding will occur as well as any third-party guarantees. The allowance for unfunded commitments is included in other liabilities on the Company's consolidated balance sheet.

Loans Acquired through Third Party Lending Programs

The loan portfolio includes commercial and industrial loans that were originated by a third-party and were acquired at premiums. Premiums on performing loans are amortized into interest income and fees on loans over the life of the loans using the effective interest method. Premiums on non-performing loans are not amortized into interest income and fees on loans after loans are placed on non-accrual status and are included in the calculation of specific reserve component of the allowance for credit losses on loans for individually analyzed loans.

Loans Acquired in a Business Combination

Acquired loans are recorded at their fair value at acquisition date without carryover of the acquiree's previously established ACLL, as credit discounts are included in the determination of fair value. The fair value of the loans is determined using market participant assumptions in estimating the amount and timing of both principal and interest cash flows expected to be collected on the loans and then applying a market-based discount rate to those cash flows. During evaluation upon acquisition, acquired loans are also classified as either PCD or Non-PCD. Acquired loans are subject to the Company's ACLL policy upon acquisition.

For Non-PCD loans, the difference between the fair value and unpaid principal balance of the loan at acquisition date (premium or discount) is amortized or accreted into interest income over the life of the loans in accordance with ASC 310-20, *Receivables – Nonrefundable Fees and Other Costs*. If the acquired performing loan has revolving privileges, it is accounted for using the straight-line method; otherwise, the effective interest method is used.

PCD loans are loans that have experienced more-than-insignificant credit deterioration since origination. PCD loans are recorded at the amount paid. An ACLL is determined using the same methodology as other loans held for investment (LHFI). The sum of the loan's purchase price and ACLL becomes its initial amortized cost basis. The difference between the initial amortized cost basis and the par value of the loan is a noncredit discount or premium, which is amortized into interest income over the life of the loan under ASC 310-20, *Receivables – Nonrefundable Fees and Other Costs*. If the loan has revolving privileges, the discount/premium is amortized/accreted using the straight-line method; otherwise, the effective interest method is used. Subsequent changes to the ACLL are recorded through provision expense.

Goodwill

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, 2023 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 loans individually evaluated.

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, 2023, commitments to extend credit, stand-by letters of credit, and rate lock commitments totaled \$207.0 million.

Construction and Land Development Lending

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

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 and loans purchased through a third-party lending programs. 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. Loans purchased through third-party lending programs included in this category carry risks associated with the borrower, changes in the economic environment, the potential for accelerated amortization of purchase premiums, 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.

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.

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 credit 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, and general and administrative expenses.

Net Interest Income

Net interest income decreased \$2.2 million, or 5%, to \$43.4 million for 2023 compared to the prior year. Total interest expense increased by \$10.5 million and was partially offset by total interest income, which increased by \$8.3 million. The net interest margin decreased by 3-basis points to 3.41% and average earnings assets decreased by \$51.6 million, or 4%.

The increase in total interest income was primarily attributable to a \$7.6 million, or 18%, increase in interest income and fees on loans. The increase in interest income on loans was attributable to a 48-basis point increase in the yield on loans and a 7% increase in average loan balances compared to the prior year.

The increase in total interest expense was attributable to a \$10.4 million increase in interest expense on deposits. The higher interest expense on deposits resulted from a 126-basis point increase in the cost of interest-bearing deposits, which was partially offset by the impact of a 3% decrease in average interest-bearing deposits. The increase in the cost of deposits was impacted by a change in the composition of the deposit portfolio as lower cost deposit balances decreased, while higher cost deposit balances increased.

The net interest margin was 3.41% for the year ended December 31, 2023 compared to the 3.44% for the prior year as the increase in the cost of funds exceeded the increase in yield on earning assets during 2023. Although the interest rate environment continued to be challenging during the year, the net interest margin was stable over the last three quarters of 2023 as the rising cost of funds was offset by an increase in earning asset yields.

The following table provides information on average interest-earning assets and interest-bearing liabilities for the years ended December 31, 2023 and 2022 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,					
	2023			2022		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets						
Interest-bearing deposits in other banks	\$ 36,050	\$ 1,809	5.02%	\$ 107,530	\$ 1,223	1.14%
Securities:						
Taxable	252,470	5,286	2.09%	284,380	5,131	1.80%
Tax-exempt (1)	53,524	1,545	2.89%	65,836	1,555	2.36%
Restricted	1,923	111	5.79%	1,887	92	4.87%
Total securities	307,917	6,942	2.25%	352,103	6,778	1.93%
Loans: (2)						
Taxable	937,013	49,293	5.26%	872,440	41,700	4.78%
Tax-exempt (1)	—	—	0.00%	548	25	4.49%
Total loans	937,013	49,293	5.26%	872,988	41,725	4.78%
Federal funds sold	—	—	0.00%	1	—	2.25%
Total earning assets	1,280,980	58,044	4.53%	1,332,622	49,726	3.73%
Less: allowance for credit losses on loans	(8,994)			(6,013)		
Total nonearning assets	91,353			82,101		
Total assets	<u>\$1,363,339</u>			<u>\$1,408,710</u>		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Checking	\$ 269,551	\$ 4,538	1.68%	\$ 295,530	\$ 1,394	0.47%
Money market accounts	219,655	4,882	2.22%	218,783	930	0.43%
Savings accounts	173,075	211	0.12%	205,532	173	0.08%
Certificates of deposit:						
Less than \$100	84,387	1,641	1.94%	74,616	345	0.46%
Greater than \$100	82,184	2,275	2.77%	62,036	428	0.69%
Brokered deposits	3,061	113	3.70%	556	3	0.57%
Total interest-bearing deposits	831,913	13,660	1.64%	857,053	3,273	0.38%
Federal funds purchased	15	1	5.90%	1	—	2.27%
Subordinated debt	4,997	277	5.54%	5,379	277	5.15%
Junior subordinated debt	9,279	271	2.92%	9,279	270	2.91%
Other borrowings	1,973	97	4.90%	—	—	0.00%
Total interest-bearing liabilities	848,177	14,306	1.69%	871,712	3,820	0.44%
Noninterest-bearing liabilities						
Demand deposits	397,932			426,823		
Other liabilities	5,147			4,306		
Total liabilities	1,251,256			1,302,841		
Shareholders' equity	112,083			105,869		
Total liabilities and shareholders' equity	<u>\$1,363,339</u>			<u>\$1,408,710</u>		
Net interest income		<u>\$ 43,738</u>			<u>\$ 45,906</u>	
Interest rate spread			2.84%			3.29%
Cost of funds			1.15%			0.29%
Interest expense as a percent of average earning assets			1.12%			0.29%
Net interest margin			3.41%			3.44%

(1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 21%. The tax-equivalent adjustment was \$325 thousand for 2023, and \$331 thousand for 2022

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

Volume and Rate Years Ending December 31, 2023			
	Volume Effect	Rate Effect	Change in Income/Expense
Interest-bearing deposits in other banks	\$ (142)	\$ 729	\$ 587
Loans, taxable	3,221	4,371	7,592
Loans, tax-exempt	(25)	—	(25)
Securities, taxable	58	97	155
Securities, tax-exempt	(15)	4	(11)
Securities, restricted	2	18	20
Federal funds sold	—	—	—
Total earning assets	\$ 3,099	\$ 5,219	\$ 8,318
Checking	\$ (111)	\$ 3,255	\$ 3,144
Money market accounts	4	3,948	3,952
Savings accounts	(17)	55	38
Certificates of deposits:			
Less than \$100	50	1,245	1,295
Greater than \$100	180	1,668	1,848
Brokered deposits	49	61	110
Federal funds purchased	1	—	1
Subordinated debt	—	—	—
Junior subordinated debt	—	1	1
Other borrowings	—	—	97
Total interest-bearing liabilities	\$ 156	\$ 10,233	\$ 10,486
Change in net interest income	\$ 2,943	\$ (5,014)	\$ (2,168)

Provision for Credit Losses

Provision for credit losses totaled \$6.2 million in 2023, compared to a provision for credit losses of \$1.9 million for the prior year. The provision was comprised of a \$6.0 million provision for credit losses on loans, a \$260 thousand provision for credit losses on unfunded commitments, and a \$26 thousand recovery of credit losses on held-to-maturity securities.

For the year ended December 31, 2023, the provision for credit losses on loans of \$6.0 million, the adjustment for the adoption of ASU 2016-13 of \$2.1 million, and net charge offs of \$3.6 million resulted in a \$4.5 million increase in the allowance for credit losses on loans. The \$3.6 million of net charge-offs included \$1.7 million of loans purchased through a third-party lending program and \$830 thousand of related unamortized purchase premiums on the loans.

The general reserve component of the ACLL increased \$2.7 million and the specific reserve component of the ACLL increased \$1.8 million. The increase in the general reserve was attributable to loan growth, higher calculated loss rates, and from the recognition of higher inherent risk in the loan portfolio through adjustments to qualitative risk factors. The specific reserve increased by \$1.8 million from fourteen new individually evaluated loan relationships and from two loans to one customer, which were individually analyzed for specific reserves in prior periods. All new individually evaluated loan relationships were loans purchased through a third-party lending program.

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.

Noninterest Income

Noninterest income totaled \$11.8 million for the year, which was a decrease of \$866 thousand, or 7%, compared to \$12.6 million for the prior year. The decrease was primarily a result of a gain on sale of other investment of \$2.9 million in the prior year, which was partially offset by \$2.0 million of net losses on sale of securities available for sale in the prior year. The gain on sale of other investment resulted from a gain on sale of an interest in a broker-dealer of investment securities by First Bank Financial Services, Inc. Noninterest income categories with moderate increases over the prior year included service charges on deposits, which increased \$103 thousand, or 4%, ATM and check card fees, which increased \$149 thousand, or 5%, and wealth management fees, which increased \$112 thousand, or 4%. Categories that decreased over the prior year included brokered mortgage fees, which decreased \$126 thousand, or 51%, and other operating income, which decreased \$417 thousand. Brokered mortgage fees decreased from less demand for mortgage loans from customers as home purchases and refinance opportunities were likely impacted by the higher interest rate environment. Other operating income decreased primarily from a recovery on a purchased loan in the prior year, which was partially offset by an increase in referral fee income.

Noninterest Expense

Noninterest expense increased \$1.6 million, or 5%, for the year ended December 31, 2023, compared to the prior year. Categories with the largest increases over the prior year included salaries and employee benefits which increased \$330 thousand, or 2%, legal and professional fees increased by \$233 thousand, or 17%, ATM and check card expense increased by \$208 thousand, or 15%, FDIC assessment increased by \$170 thousand, or 37%, and other operating expenses increased by \$444 thousand, or 11%. Other operating expense increased from higher recruiting expense, directors' fees, cardcash expense, education and training, loan collection expense, and courier and armored services.

Income Taxes

Income tax expense decreased \$1.8 million during the year ended December 31, 2023 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, 2023 and 2022. 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 increased \$49.9 million during the year and totaled \$1.4 billion at December 31, 2023. The increase was primarily attributable to a \$44.4 million increase in loans, net of allowance and a \$23.8 million increase in interest-bearing deposits in banks, which was partially offset by a \$10.1 million decrease in securities available for sale, and a \$4.9 million decrease in securities held to maturity.

Total liabilities increased \$42.0 million during the year and totaled \$1.3 billion at December 31, 2023. Total deposits decreased \$7.6 million and was offset by other borrowings, which increased \$50.0 million. Total deposits decreased as noninterest-bearing demand deposits decreased by \$48.1 million and savings and interest-bearing deposits decreased by \$15.0 million, while time deposits increased \$55.5 million.

Total shareholders' equity increased \$7.9 million to \$116.3 million at December 31, 2023, compared to \$108.4 million at December 31, 2022. The increase was primarily attributable to a \$3.8 million decrease in accumulated other comprehensive loss and a \$3.9 million increase in retained earnings.

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, and small and medium-sized businesses 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 \$128 thousand and \$350 thousand at December 31, 2023 and 2022, respectively; with \$128 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 ACLL through additional provision for credit losses charged to earnings.

The loan portfolio includes loans that were acquired through business combinations. Loans acquired through business combinations included unamortized discounts, net of unamortized premiums totaling \$1.9 million and \$2.5 million, as of December 31, 2023 and 2022, respectively, which are amortized over the life of the loans.

The loan portfolio also includes loans that were acquired through business combinations and loans that were purchased through a third-party loan originator. Loans acquired through business combinations included unamortized discounts, net of unamortized premiums totaling \$1.9 million and \$2.5 million, as of December 31, 2023 and 2022, respectively.

Loans purchased from a third-party that originated and serviced loans to health care professionals totaled \$24.6 million as of December 31, 2023, which included unamortized premiums totaling \$7.9 million, compared to loans totaling \$22.3 million as of December 31, 2022, which included unamortized premiums totaling \$7.4 million.

Loans increased \$48.9 million to \$969.4 million at December 31, 2023, compared to \$920.5 million at December 31, 2022. Other real estate loans increased by \$28.8 million, residential real estate loans increased by \$12.9 million, consumer and other loans increased by \$4.5 million, commercial, and industrial loans increased by \$1.8 million, and construction and land development loans increased by \$840 thousand.

The following table sets forth the maturities of the loan portfolio at December 31, 2023 (in thousands):

Maturity/Repricing Schedule of Loans Held for Investment						
December 31, 2023						
	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	\$ 8,264	\$ 8,324	\$ 6,103	\$ 14,835	\$ 364	\$ 37,890
1 to 5 years	9,488	8,136	11,205	1,911	—	30,740
5 to 15 years	13,988	135,710	153,437	6,637	3,236	313,008
After 15 years	2,390	49,305	82,432	—	—	134,127
Fixed Rate:						
Within 1 year	5,051	3,274	5,131	4,689	235	18,380
1 to 5 years	1,805	20,593	95,231	46,230	7,733	171,592
5 to 15 years	7,095	83,106	91,907	36,648	468	219,224
After 15 years	4,599	35,921	1,825	2,124	—	44,469
	<u>\$ 52,680</u>	<u>\$ 344,369</u>	<u>\$ 447,271</u>	<u>\$ 113,074</u>	<u>\$ 12,036</u>	<u>\$ 969,430</u>

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 \$0 and \$184 thousand in assets classified as OREO at December 31, 2023 and 2022, respectively.

Non-performing assets totaled \$6.8 million and \$2.9 million at December 31, 2023 and 2022, representing approximately 0.48% and 0.21% of total assets, respectively. Non-performing assets consisted of \$6.8 million of non-accrual loans at December 31, 2023. Non-performing assets consisted of \$184 thousand of OREO and \$2.7 million of non-accrual loans and at December 31, 2022.

At December 31, 2023, 92.1% of non-performing assets were commercial and industrial loans, 7.3% were residential real estate loans, 0.6% construction 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 \$287 thousand and \$2.3 million at December 31, 2023 and December 31, 2022, 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 \$524 thousand loans greater than 90 days past due and still accruing at December 31, 2023. There were no loans greater than 90 days past due and still accruing at December 31, 2022.

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 of these loans resumed regular payments during 2023.

The ACLL represents management's analysis of the existing loan portfolio and related credit risks. The provision for credit losses is based upon management's current estimate of the amount required to maintain an adequate ACLL reflective of the risks in the loan portfolio. The allowance for credit losses on loans totaled \$12.0 million at December 31, 2023 and \$7.4 million at December 31, 2022, representing 1.24% and 0.81% of total loans, respectively. The Company determined that the historical loss analysis and the qualitative adjustment factors that established the general reserve component of the ACLL were appropriate at December 31, 2023. The allowance for credit losses on loans as a percentage of total loans increased to 1.24% at December 31, 2023 compared to 0.81% at December 31, 2022 as a result of a \$2.9 million increase in the general reserve and a \$1.8 million increase in the specific reserve component of the ACLL.

For further discussion regarding the ACLL, see "Provision for Credit Losses" above.

A recovery of credit losses of \$593 thousand was recorded in the other real estate class during the year ended December 31, 2023. The recovery of credit losses resulted primarily from a decrease in the general reserve. This recovery was offset by provision for credit losses totaling \$6.5 million in the construction and land development, 1-4 family residential, commercial and industrial, and consumer loan classes. For more detailed information regarding the provision for credit losses on loans, see Note 4 to the Consolidated Financial Statements included in this Form 10-K.

Loans individually evaluated for impairment totaled \$6.8 million and \$2.7 million at December 31, 2023 and 2022, respectively. The related allowance for credit losses required for these loans totaled \$2.7 million and \$888 thousand at December 31, 2023 and December 31, 2022, respectively.

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 credit losses on loans charged to expense was based on 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 credit losses. There can be no assurance, however, that an additional provision for credit 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 ACLL, see "Critical Accounting Policies" above. The following table shows a detail of loans charged-off, recovered, and the changes in the ACLL (dollars in thousands).

Allowance for credit 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, 2022:						
Balance at beginning of year	\$ 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) credit losses	191	18	364	1,043	234	1,850
Balance at end of year	<u>\$ 546</u>	<u>\$ 1,108</u>	<u>\$ 3,609</u>	<u>\$ 1,874</u>	<u>\$ 309</u>	<u>\$ 7,446</u>
Average loans	\$ 49,671	\$ 308,276	\$ 399,395	\$ 107,561	\$ 8,085	\$ 872,988
Ratio of net (recoveries) charge-offs to average loans	-0.02%	0.00%	0.00%	-0.11%	3.28%	0.01%
For the year ended December 31, 2023:						
Balance at beginning of year	\$ 546	\$ 1,108	\$ 3,609	\$ 1,874	\$ 309	\$ 7,446
Adjustment to allowance for adoption of ASU 2016-13	(313)	1,409	1,702	(387)	(225)	2,186
Charge-offs	—	(59)	(34)	(3,452)	(448)	(3,993)
Recoveries	—	47	14	145	212	418
Provision for (recovery of) credit losses	79	654	(593)	5,526	251	5,917
Balance at end of year	<u>\$ 312</u>	<u>\$ 3,159</u>	<u>\$ 4,698</u>	<u>\$ 3,706</u>	<u>\$ 99</u>	<u>\$ 11,974</u>
Average loans	\$ 49,950	\$ 337,278	\$ 427,094	\$ 112,822	\$ 9,868	\$ 937,012
Ratio of net (recoveries) charge-offs to average loans	0.00%	0.00%	0.00%	2.93%	2.39%	0.38%

The following table shows the balance of the Bank's ACLL 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 Credit Losses

	At December 31,	
	2023	2022
Allocation of Allowance for Credit Losses:		
Real estate loans:		
Construction and land development	\$ 312	\$ 546
Secured by 1-4 family	3,159	1,108
Other real estate loans	4,698	3,609
Commercial and industrial	3,706	1,874
Consumer and other loans	99	309
Total allowance for credit losses	<u>\$ 11,974</u>	<u>\$ 7,446</u>
Ratios of loans to total period-end loans:		
Real estate loans:		
Construction and land development	5.4%	5.6%
Secured by 1-4 family	35.5%	36.0%
Other real estate loans	46.1%	45.5%
Commercial and industrial	11.7%	12.1%
Consumer and other loans	1.2%	0.8%
	<u>100.0%</u>	<u>100.0%</u>

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

	Non-performing Assets	
	At December 31,	
	2023	2022
Non-accrual loans	\$ 6,763	\$ 2,673
Other real estate owned	—	184
Total non-performing assets	\$ 6,763	\$ 2,857
Loans past due 90 days accruing interest	524	—
Total non-performing assets and past due loans	\$ 7,287	\$ 2,857
Troubled debt restructurings	\$ —	\$ 101
Non-performing assets to period end loans	0.75%	0.31%

The following table summarizes the Company's credit ratios on a consolidated basis as of December 31, 2023 and 2022.

	Consolidated Credit Ratios	
	December 31, 2023	
	2023	2022
Total Loans	\$ 969,430	\$ 920,523
Nonaccrual loans	\$ 6,763	\$ 2,673
Allowance for credit losses (ACL)	\$ 11,974	\$ 7,446
Nonaccrual loans to total loans	0.70%	0.29%
ACL to total loans	1.24%	0.81%
ACL to nonaccrual loans	177.05%	278.56%

The Company purchased commercial and industrial loans between October 2021 and October 2023 from a third-party finance company that originated and serviced loans to health care professionals. The finance company operated a program that historically provided credit support to the Company through, among other things, the repurchase of their loans and unamortized loan premiums when loans did not pay according to the loan agreements. The Company performed an evaluation of the purchased loans, which resulted in a loss classification for \$1.7 million of the loans and \$830 thousand of their unamortized premiums. The classifications resulted in charge offs of the loans and unamortized premiums totaling \$2.5 million to the allowance for credit losses on loans during the fourth quarter of 2023. On December 31, 2023, loans purchased from the finance company totaled \$24.5 million, which was comprised of \$16.6 million of loan balances and unamortized premiums totaling \$7.9 million. The Company determined that \$2.4 million of the loans were non-accrual and thus were individually evaluated. Specific reserves on the individually evaluated loans were included in the Company's allowance for credit losses on loans. The remaining \$22.1 million of loans were considered performing and were included in the calculation of the general reserve component of the allowance for credit losses. Premiums are amortized over the life of the loans using the effective interest method. On December 31, 2023, there was a total of 172 loans purchased from the finance company included in the Company's loan portfolio with a weighted average maturity of 7.5 years.

Securities

Securities totaled \$303.2 million at December 31, 2023, a decrease of \$14.8 million, or 4.7%, from \$318.0 million at the end of 2022. 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, 2023, 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 \$61 thousand and \$99 thousand at December 31, 2023 and 2022, respectively. Gross unrealized losses in the available for sale portfolio totaled \$20.7 million and \$24.0 million at December 31, 2023 and 2022, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$107 thousand and \$0 at December 31, 2023 and 2022, respectively. Gross unrealized losses in the held to maturity portfolio totaled \$10.8 million and \$11.4 thousand at December 31, 2023 and 2022, respectively. The change in the unrealized gains and losses of investment securities from December 31, 2022 to December 31, 2023 was related to changes in market interest rates and was not related to credit concerns of the issuers.

The Company evaluated securities available for sale in an unrealized loss position for credit related impairment and determined that no allowance for credit losses was necessary at December 31, 2023 and 2022. At December 31, 2023, the allowance for credit losses on held to maturity securities was \$107 thousand. There was no allowance for credit losses on held to maturity securities at December 31, 2022.

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, 2023 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, 2023

	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	\$ 29,703	\$ 21,858	\$ —	\$ —	\$ 51,561
Market value	\$ 29,489	\$ 20,657	\$ —	\$ —	\$ 50,146
Weighted average yield	3.46	2.22%	—%	—%	2.94%
U.S. agency and mortgage-backed securities					
Amortized cost	\$ —	\$ 17,511	\$ 29,535	\$ 144,508	\$ 191,554
Market value	\$ —	\$ 16,299	\$ 27,552	\$ 126,574	\$ 170,425
Weighted average yield	—%	2.33%	3.05%	2.39%	2.49%
Obligations of state and political subdivisions					
Amortized cost	\$ 1,747	\$ 6,420	\$ 24,379	\$ 43,148	\$ 75,694
Market value	\$ 1,739	\$ 6,308	\$ 21,933	\$ 37,440	\$ 67,420
Weighted average yield	3.57%	3.27%	2.25%	2.53%	2.53%
Corporate debt securities					
Amortized cost	\$ —	\$ —	\$ 3,000	\$ —	\$ 3,000
Market value	\$ —	\$ —	\$ 2,480	\$ —	\$ 2,480
Weighted average yield	—%	—%	4.50	—%	4.50%
Restricted securities					
Amortized cost	\$ —	\$ —	\$ —	\$ 2,078	\$ 2,078
Market value	\$ —	\$ —	\$ —	\$ 2,078	\$ 2,078
Weighted average yield	—%	—%	—%	5.36%	5.36%
Total portfolio					
Amortized cost	\$ 31,450	\$ 45,789	\$ 56,914	\$ 189,734	\$ 323,887
Market value	\$ 31,228	\$ 43,264	\$ 51,965	\$ 166,092	\$ 292,549
Weighted average yield (1)	3.47%	2.41%	2.79%	2.46%	2.61%

(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, 2023, 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, 2023, deposits totaled \$1.2 billion, decreasing slightly by \$7.6 million, from \$1.2 billion at December 31, 2022. There was a change in the deposit mix when comparing the periods. At December 31, 2023, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 31%, 54%, and 15% of total deposits, respectively, compared to 34%, 55%, and 11% at December 31, 2022.

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,			
	2023		2022	
	Amount	Rate	Amount	Rate
Noninterest-bearing deposits	\$ 397,932	—%	\$ 426,823	—%
Interest-bearing deposits:				
Interest checking	\$ 269,551	1.68%	\$ 295,530	0.47%
Money market	219,655	2.22%	218,783	0.43%
Savings	173,075	0.12%	205,532	0.08%
Time deposits:				
Less than \$100	84,387	1.94%	74,616	0.46%
Greater than \$100	82,184	2.77%	62,036	0.69%
Brokered deposits	3,061	3.70%	556	0.57%
Total interest-bearing deposits	\$ 831,913	1.64%	\$ 857,053	0.38%
Total deposits	\$ 1,229,845		\$ 1,283,876	

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

As of December 31, 2023 the estimated amount of total uninsured deposits was \$368.2 million. Maturities of the estimated amount of uninsured time deposits at December 31, 2023 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, 2023
3 months or less	\$ 5,157
3-6 months	5,555
6-12 months	4,967
Over 12 months	7,802
	<u>\$ 23,481</u>

Liquidity

Liquidity sources available to the Bank, including interest-bearing deposits in banks, unpledged securities available for sale, at fair value, unpledged securities held-to-maturity, at par, eligible to be pledged to the Federal Reserve Bank through its Bank Term Funding Program, and available lines of credit totaled \$512.7 million on December 31, 2023, and \$417.2 million on December 31, 2022. Available lines of credit from other institutions included in the total amount above was \$351.4 million on December 31, 2023, and \$287.3 million on December 31, 2022. The available lines of credit were comprised of secured and unsecured lines of credit and the Bank had no borrowings on the lines as of December 31, 2023 and December 31, 2022.

The Bank maintains liquidity to fund loan growth and meet the potential demand from its deposit customers, including potential volatile deposits. The estimated amount of uninsured customer deposits totaled \$368.2 million on December 31, 2023, and \$261.7 million on December 31, 2022. Excluding municipal deposits, the estimated amount of uninsured customer deposits totaled \$286.2 million on December 31, 2023, and \$185.3 million on December 31, 2022.

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, 2023 and 2022, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	2023	2022
Commitments to extend credit and unfunded commitments under lines of credit	\$ 194,242	\$ 158,297
Stand-by letters of credit	11,615	17,950

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

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and may or may not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary.

At December 31, 2023, the Bank had \$1.2 million in locked-rate commitments to originate mortgage loans. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

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

The interest rate swaps qualified and are designated as cash flow hedges. The Company's cash flow hedges effectively modify the Company's exposure to interest rate risk by converting variable rates of interest on \$9.0 million of the Company's junior subordinated debt to fixed rates of interest for periods that end between June 2034 and October 2036. The cash flow hedges' total notional amount is \$9.0 million. At December 31, 2023, the cash flow hedges had a fair value of \$2.5 million, 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 not 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, 2023 and December 31, 2022, 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, 2023, and 2022 (dollars in thousands).

	Analysis of Capital	
	At December 31,	
	2023	2022
Common equity Tier 1 capital	\$ 129,840	\$ 132,103
Tier 1 capital	129,840	132,103
Tier 2 capital	12,493	7,446
Total risk-based capital	142,333	139,549
Risk-weighted assets	1,012,843	955,779
Capital ratios:		
Common equity Tier 1 capital ratio	12.82%	13.82%
Tier 1 capital ratio	12.82%	13.82%
Total capital ratio	14.05%	14.60%
Leverage ratio (Tier 1 capital to average assets)	9.31%	9.36%
Capital conservation buffer ratio(1)	6.05%	6.60%

- (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, 2023 and 2022.

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. 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, 2023, it may opt into the CBLR framework in a future quarterly period.

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. During the year ended December 31, 2023 the Company repurchased 37,532 shares of its common stock at an average price of \$15.14 per share. The Company did not repurchase any shares during the year ended December 31, 2022.

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 used 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.

First Bank remained well-capitalized at December 31, 2023.

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.

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, 2023. 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, 2023. 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, 2023. 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 2023 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 of First National Corporation

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, 2023 and 2022, the related consolidated statements of income, comprehensive income (loss), 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, 2023 and 2022, 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.

Adoption of New Accounting Standard

As discussed in Notes 1, 3 and 4 to the financial statements, the Company changed its method of accounting for credit losses in 2023 due to the adoption of Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*, including all related amendments.

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 Credit Losses – Loans Collectively Evaluated

As further described in Notes 1, 3 and 4 to the consolidated financial statements, the Company changed its method of accounting for credit losses on January 1, 2023, due to the adoption of Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*, as amended. The allowance for credit losses on loans (ACLL) is a valuation allowance that represents management's best estimate of expected credit losses on loans measured at amortized cost considering available information, from internal and external sources, relevant to assessing collectability over the loans' contractual terms. Loans which share common risk characteristics are pooled and collectively evaluated by the Company using historical data, as well as assessments of current conditions and reasonable and supportable forecasts of future conditions. The Company's ACLL related

to collectively evaluated loans represented \$9.3 million of the total recorded ACLL of \$12.0 million as of December 31, 2023. The collectively evaluated ACLL consists of quantitative and qualitative components.

For collectively evaluated loans, the quantitative component consists of loss estimates derived from a discounted cash flow model, using internal observations of historical loan losses. These loss rates are further adjusted over a reasonable and supportable forecast period based on the identified loss drivers. These estimates consider large amounts of data in tabulating default, loss given default, and prepayment speeds and require complex calculations as well as management judgment in the selection of the appropriate inputs. In addition to the quantitative component, the collectively evaluated ACLL also includes a qualitative component which aggregates management's assessment of available information relevant to assessing collectability that is not captured in the quantitative loss estimation process. Factors considered by management in developing its qualitative estimates include: variability in the economic forecast, changes in the volume and severity of classified loans, changes in concentrations of credit, changes in the nature and volume of the loan segments, factors related to credit administration, and other risks not embedded in the data utilized in the model.

Management exercised significant judgment when estimating the ACLL on collectively evaluated loans. We identified the estimation of the collectively evaluated ACLL as a critical audit matter as auditing the collectively evaluated ACLL involved especially complex and subjective auditor judgment in evaluating management's assessment of the inherently subjective estimates.

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

- Obtaining an understanding of the Company's process for determining its ACLL, including the underlying methodology and significant inputs to the calculation.
- Substantively testing management's process for measuring the collectively evaluated ACLL, including:
 - Evaluating the conceptual soundness, assumptions, and key data inputs of the Company's discounted cash flow methodology, including the identification of loan pools, loss driver assumptions, the probability of default and loss given default rate inputs, and the prepayment/curtailment rate inputs for each pool.
 - Evaluating management's selection of forecasting inputs and testing the accuracy of management's incorporation of its forecasts in the collectively evaluated ACLL estimate.
 - Evaluating the completeness and accuracy of data inputs used as a basis for the qualitative factors.
 - Evaluating the qualitative factors for directional consistency in comparison to prior periods and for reasonableness in comparison to underlying supporting data.
 - Testing the mathematical accuracy of the ACLL for collectively evaluated loans including both the discounted cashflow and qualitative factor components of the calculations.

/s/ Yount, Hyde & Barbour, P.C.

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

Winchester, Virginia
March 29, 2024

FIRST NATIONAL CORPORATION**Consolidated Balance Sheets**

December 31, 2023 and 2022

(in thousands, except share and per share data)

	<u>2023</u>	<u>2022</u>
Assets		
Cash and due from banks	\$ 17,194	\$ 20,784
Interest-bearing deposits in banks	69,967	46,130
Securities available for sale, at fair value	152,857	162,907
Securities held to maturity, at amortized cost (net of allowance for credit losses of \$107 at December 31, 2023)	148,244	153,158
Restricted securities, at cost	2,078	1,908
Loans, net of allowance for credit losses, 2023, \$11,974, 2022, \$7,446	957,456	913,077
Other real estate owned, net of valuation allowance, 2023, \$0, 2022, \$13	—	184
Premises and equipment, net	22,142	21,876
Accrued interest receivable	4,655	4,543
Bank owned life insurance	24,902	24,531
Core deposit intangibles, net	117	136
Goodwill	3,030	3,030
Other assets	16,653	17,119
Total assets	<u>\$ 1,419,295</u>	<u>\$ 1,369,383</u>
Liabilities & Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 379,208	\$ 427,344
Savings and interest-bearing demand deposits	662,169	677,139
Time deposits	192,349	136,849
Total deposits	<u>\$ 1,233,726</u>	<u>\$ 1,241,332</u>
Other borrowings	50,000	—
Subordinated debt	4,997	4,995
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	5,022	5,417
Total liabilities	<u>\$ 1,303,024</u>	<u>\$ 1,261,023</u>
Commitments and contingencies		
Shareholders' Equity		
Preferred stock, par value \$1.25 per share; authorized 1,000,000 shares; none issued and outstanding	\$ —	\$ —
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2023, 6,263,102 shares, 2022, 6,264,912 shares	7,829	7,831
Surplus	32,950	32,716
Retained earnings	94,198	90,284
Accumulated other comprehensive (loss), net	(18,706)	(22,471)
Total shareholders' equity	<u>\$ 116,271</u>	<u>\$ 108,360</u>
Total liabilities and shareholders' equity	<u>\$ 1,419,295</u>	<u>\$ 1,369,383</u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Income
Years Ended December 31, 2023 and 2022
(in thousands, except per share data)

	<u>2023</u>	<u>2022</u>
Interest and Dividend Income		
Interest and fees on loans	\$ 49,293	\$ 41,720
Interest on deposits in banks	1,809	1,223
Interest and dividends on securities:		
Taxable interest	5,286	5,131
Tax-exempt interest	1,220	1,229
Dividends	111	92
Total interest and dividend income	<u>\$ 57,719</u>	<u>\$ 49,395</u>
Interest Expense		
Interest on deposits	\$ 13,660	\$ 3,273
Interest on federal funds purchased	1	—
Interest on subordinated debt	277	277
Interest on junior subordinated debt	271	270
Interest on other borrowings	97	—
Total interest expense	<u>\$ 14,306</u>	<u>\$ 3,820</u>
Net interest income	<u>\$ 43,413</u>	<u>\$ 45,575</u>
Provision for credit losses	6,150	1,850
Net interest income after provision for credit losses	<u>\$ 37,263</u>	<u>\$ 43,725</u>
Noninterest Income		
Service charges on deposit accounts	\$ 2,780	\$ 2,677
ATM and check card fees	3,449	3,300
Wealth management fees	3,120	3,008
Fees for other customer services	770	839
Brokered mortgage fees	119	245
Income from bank owned life insurance	627	597
Net (losses) on securities available for sale	—	(2,004)
Net gains (losses) on disposal of premises and equipment	47	(29)
Gain on sale of other investment	186	2,885
Other operating income	686	1,103
Total noninterest income	<u>\$ 11,784</u>	<u>\$ 12,621</u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Income
(Continued)
Years Ended December 31, 2023 and 2022
(in thousands, except per share data)

	<u>2023</u>	<u>2022</u>
Noninterest Expense		
Salaries and employee benefits	\$ 21,039	\$ 20,709
Occupancy	2,154	2,218
Equipment	2,377	2,300
Marketing	910	813
Supplies	576	528
Legal and professional fees	1,647	1,414
ATM and check card expenses	1,578	1,370
FDIC assessment	633	463
Bank franchise tax	1,040	930
Data processing expense	1,047	989
Amortization expense	18	19
Other real estate (gain) loss and expense, net	(199)	(106)
Other operating expense	4,422	3,950
Total noninterest expense	<u>\$ 37,242</u>	<u>\$ 35,597</u>
Income before income taxes	\$ 11,805	\$ 20,749
Income tax expense	2,181	3,952
Net income	<u><u>\$ 9,624</u></u>	<u><u>\$ 16,797</u></u>
Earnings per common share		
Basic	\$ 1.54	\$ 2.69
Diluted	\$ 1.53	\$ 2.68

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Comprehensive Income (Loss)
Years Ended December 31, 2023 and 2022
(in thousands)

	<u>2023</u>	<u>2022</u>
Net income	\$ 9,624	\$ 16,797
Other comprehensive loss, net of tax:		
Unrealized holding gains (losses) on available for sale securities, net of tax \$697 and (\$5,327), respectively	2,621	(20,033)
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, 2023	—	(6,160)
Amortization of unrealized holding losses on available-for-sale securities transferred to held to maturity, net of tax of \$344 and \$125, respectively	1,295	468
Reclassification adjustment for losses included in net income, net of tax \$0 and \$421, respectively	—	1,583
Change in fair value of cash flow hedges, net of tax (\$40) and \$365, respectively	(151)	1,373
Total other comprehensive income (loss)	<u>3,765</u>	<u>(22,769)</u>
Total comprehensive income (loss)	<u>\$ 13,389</u>	<u>\$ (5,972)</u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
Years Ended December 31, 2023 and 2022
(in thousands)

	<u>2023</u>	<u>2022</u>
Cash Flows from Operating Activities		
Net income	\$ 9,624	\$ 16,797
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	1,597	1,495
Amortization of core deposit intangibles	19	18
Amortization of debt issuance costs	2	2
Provision for credit losses on loans	5,917	1,850
Provision for credit losses on unfunded commitments	260	—
Fair value adjustments on other real estate owned	—	13
Losses on securities available for sale	—	2,004
Net gains on sale of other real estate owned	(233)	(176)
Increase in cash value of bank owned life insurance	(627)	(597)
Accretion of discounts and amortization of premiums on securities, net	932	1,152
Accretion of premium on time deposits	(86)	(187)
Accretion of certain acquisition-related discounts, net	(594)	(1,130)
Stock-based compensation	753	785
Excess tax benefits on stock-based compensation	4	3
(Gains) losses on disposal of premises and equipment	(47)	29
Deferred income tax expense (benefit)	(399)	(241)
Changes in assets and liabilities:		
(Increase) in interest receivable	(112)	(640)
(Increase) decrease in other assets	188	4,918
(Decrease) increase in accrued interest payable and other liabilities	(808)	677
Net cash provided by operating activities	<u>\$ 16,390</u>	<u>\$ 26,772</u>
Cash Flows from Investing Activities		
Proceeds from maturities, calls, principal payments, and sales of securities available for sale	\$ 12,462	\$ 39,100
Proceeds from maturities, calls, and principal payments of securities held to maturity	8,485	9,239
Purchases of securities available for sale	—	(21,147)
Purchases of securities held to maturity	(2,091)	(54,038)
Net purchase of restricted securities	(170)	(95)
Purchase of premises and equipment, net	(1,866)	(1,181)
Proceeds from sale of premises and equipment	50	—
Proceeds from sale of other real estate owned	417	2,011
Proceeds from cash value of bank owned life insurance	256	360
Net (increase) in loans	(51,888)	(94,389)
Net cash used in investing activities	<u>\$ (34,345)</u>	<u>\$ (120,140)</u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows

(Continued)

Years Ended December 31, 2023 and 2022

(in thousands)

	<u>2023</u>	<u>2022</u>
Cash Flows from Financing Activities		
Net (decrease) increase in demand deposits and savings accounts	\$ (63,106)	\$ 1,297
Net increase (decrease) in time deposits	55,586	(8,530)
Increase in other borrowings	50,000	—
Repayment of subordinated debt	—	(5,000)
Cash dividends paid on common stock, net of reinvestment	(3,596)	(3,308)
Repurchase of common stock, stock incentive plan	(568)	(183)
Repurchase of common stock, stock repurchase plan	(114)	—
Net cash provided by (used in) financing activities	<u>\$ 38,202</u>	<u>\$ (15,724)</u>
Increase (decrease) in cash and cash equivalents	<u>\$ 20,247</u>	<u>\$ (109,092)</u>
Cash and Cash Equivalents		
Beginning	66,914	176,006
Ending	<u><u>\$ 87,161</u></u>	<u><u>\$ 66,914</u></u>
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	<u>\$ 9,355</u>	<u>\$ 3,996</u>
Income taxes	<u>\$ 3,426</u>	<u>\$ 3,365</u>
Supplemental Disclosures of Noncash Transactions		
Unrealized gain (losses) on securities available for sale	<u>\$ 3,318</u>	<u>\$ (23,356)</u>
Unrealized losses on securities transferred from available for sale to held to maturity	<u>\$ —</u>	<u>\$ (7,205)</u>
Fair value of securities transferred from available for sale to held to maturity	<u>\$ —</u>	<u>\$ 74,416</u>
Change in fair value of cash flow hedges	<u>\$ (191)</u>	<u>\$ 1,738</u>
Transfer from premises and equipment to other real estate owned, net	<u>\$ —</u>	<u>\$ (184)</u>
Lease liabilities arising from obtaining right-of-use assets during the period	<u>\$ 20</u>	<u>\$ 491</u>
Issuance of common stock, dividend reinvestment plan	<u><u>\$ 161</u></u>	<u><u>\$ 194</u></u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Changes in Shareholders' Equity

Years Ended December 31, 2023 and 2022

(in thousands, except share and per share data)

	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	<u>\$ 7,831</u>	<u>\$ 32,716</u>	<u>\$ 90,284</u>	<u>\$ (22,471)</u>	<u>\$ 108,360</u>

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2022	\$ 7,831	\$ 32,716	\$ 90,284	\$ (22,471)	\$ 108,360
Adoption of new accounting standard (ASU 2016-13)	—	—	(1,953)	—	(1,953)
Net income	—	—	9,624	—	9,624
Other comprehensive income	—	—	—	3,765	3,765
Cash dividends on common stock (\$0.60 per share)	—	—	(3,757)	—	(3,757)
Stock-based compensation	—	753	—	—	753
Issuance of 9,214 shares common stock, dividend reinvestment plan	12	149	—	—	161
Issuance of 33,002 shares common stock, stock incentive plan	41	(41)	—	—	—
Repurchase of 6,495 shares common stock, stock incentive plan	(8)	(106)	—	—	(114)
Repurchase of 37,532 shares common stock, stock repurchase plan	(47)	(521)	—	—	(568)
Balance, December 31, 2023	<u>\$ 7,829</u>	<u>\$ 32,950</u>	<u>\$ 94,198</u>	<u>\$ (18,706)</u>	<u>\$ 116,271</u>

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Notes to Consolidated Financial Statements

Note 1. Nature of Banking Activities and Significant Accounting Policies

First National Corporation (the Company) is the bank holding company of First Bank (the Bank). 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 credit 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.

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 evaluates the fair value and credit quality of its AFS securities on at least a quarterly basis. In the event the fair value of a security falls below its amortized cost basis, the security is evaluated to determine whether the decline in value was caused by changes in market interest rates or security credit quality. The primary indicators of credit quality for the Company's AFS portfolio are security type and credit rating, which are influenced by a number of security-specific factors that may include obligor cash flow, geography, seniority, structure, credit enhancement, and other factors.

If unrealized losses are related to credit quality, the Company estimates the credit related loss by evaluating the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security and a credit loss exists, an ACL is recorded for the credit loss, limited by the amount that the fair value is less than

The Company evaluates the credit risk of its HTM securities on at least a quarterly basis. The Company estimates expected credit losses on HTM debt securities on an individual basis based on the probability of default/loss given default methodology. The primary indicators of credit quality for the Company's HTM portfolio are security type and credit rating, which is influenced by a number of factors including obligor cash flow, geography, seniority, and others. The majority of the Company's HTM securities with credit risk are obligations of states and political subdivisions.

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 and through the purchase of commercial loans through third party lending programs. 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 ACLL 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.

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, 2023 and 2022. 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 2023 and 2022 was \$573 thousand and \$455 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.

Adoption of New Accounting Pronouncements

ASU 2016-13: On January 1, 2023, the Company adopted Accounting Standards Update (ASU) No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” (Accounting Standards Codification (ASC) 326). This standard replaced the incurred loss methodology with an expected loss methodology that is referred to as the current expected credit loss (CECL) methodology. CECL requires an estimate of credit losses for the remaining estimated life of the financial asset using historical experience, current conditions, and reasonable and supportable forecasts and generally applies to financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities, and some off-balance sheet credit exposures such as unfunded commitments to extend credit. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses.

In addition, CECL made changes to the accounting for available for sale debt securities. One such change is to require credit losses to be presented as an allowance rather than as a write-down on available for sale debt securities if management does not intend to sell and does not believe that it is more likely than not that they will be required to sell.

The Company adopted ASC 326 and all related subsequent amendments thereto effective January 1, 2023 using the modified retrospective approach for all financial assets measured at amortized cost and off-balance sheet credit exposures. The transition adjustment of the adoption of CECL included an increase in the allowance for credit losses on loans of \$2.2 million, which is presented as a reduction to net loans outstanding, and an increase in the allowance for credit losses on unfunded commitments of \$153 thousand, which is recorded within other liabilities. The Company recorded an allowance for credit losses for held to maturity securities of \$134 thousand, which is presented as a reduction to held to maturity securities outstanding. The Company recorded a net decrease to retained earnings of \$2.0 million as of January 1, 2023 for the cumulative effect of adopting CECL, which reflects the transition adjustments noted above, net of the applicable deferred tax assets recorded. Results for reporting periods beginning after January 1, 2023 are presented under CECL while prior period amounts continue to be reported in accordance with previously applicable accounting standards.

The Company adopted ASC 326 using the prospective transition approach for purchase credit deteriorated (PCD) assets that were previously classified as purchase credit impaired (PCI) under ASC 310-30. In accordance with the standard, management did not reassess whether PCI assets met the criteria of PCD assets as of the date of adoption. As of December 31, 2023, the Company had no loans classified as PCD.

The Company adopted ASC 326 using the prospective transition approach for debt securities for which other-than-temporary impairment had been recognized prior to January 1, 2023. As of December 31, 2022, the Company did not have any other-than-temporary impaired investment securities. Therefore, upon adoption of ASC 326, the Company determined that an allowance for credit losses on available for sale securities was not required.

The Company elected not to measure an allowance for credit losses for accrued interest receivable and instead elected to reverse interest income on loans or securities that are placed on nonaccrual status, which is generally when the instrument is 90 days past due, or earlier if the Company believes the collection of interest is doubtful. The Company has concluded that this policy results in the timely reversal of uncollectible interest.

	January 1, 2023 As reported Under ASC 326	December 31, 2022 Pre-ASC 326 Adoption	Impact of ASC 326 Adoption
<i>(dollars in thousands)</i>			
Assets:			
Allowance for credit losses on held to maturity securities:			
Corporate securities	134	-	134
Allowance for credit losses on loans:			-
Construction and land development	233	546	(313)
Secured by 1-4 family residential	2,517	1,108	1,409
Other real estate loans	5,311	3,609	1,702
Commercial and industrial loans	1,487	1,874	(387)
Consumer and other loans	84	309	(225)
Allowance for credit losses on loans	9,632	7,446	2,186
Liabilities:			
Allowance for credit losses for unfunded commitments	153	-	153

Allowance for Credit Losses - Held-to-Maturity Securities

The Company estimates expected credit losses on held-to-maturity securities on an individual basis based on a Probability of Default/Loss Given Default ("PD/LGD") methodology primarily using security-level credit ratings. The primary indicators of credit quality for the Company's held-to-maturity portfolio are security type and credit ratings, which are influenced by a number of factors including obligor cash flow, geography, seniority, among other factors. The Company's held-to-maturity securities with credit risk are municipal bonds and corporate debt securities. All other held-to-maturity securities are covered by the explicit or implied guarantee of the United States government or one of its agencies.

Changes in the allowance for credit loss are recorded as provision for (or recovery of) credit losses in the Consolidated Statements of Income. The Company recorded an allowance for credit losses on held-to-maturity securities of \$134 thousand upon adoption of ASC 326. During the year ended December 31, 2023, the Company recorded a recovery of credit losses on held-to-maturity securities of \$107 thousand. There was no allowance for credit losses on held-to-maturity securities at December 31, 2022.

Allowance for Credit Losses – Available-for-Sale Securities

Management evaluates all available-for-sale securities in an unrealized loss position on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. If the Company has the intent to sell the security or it is more likely than not that the Company will be required to sell the security, the security is written down to fair value and the entire loss is recorded in earnings.

If either of the above criteria is not met, the Company evaluates whether the decline in fair value is the result of credit losses or other factors. In making the assessment, the Company may consider various factors including the extent to which fair value is less than amortized cost, downgrades in the ratings of the security by a rating agency, the failure of the issuer to make scheduled interest or principal payments and adverse conditions specific to the security. If the assessment indicates that a credit loss exists, the present value of cash flows expected to be collected are compared to the amortized cost basis of the security and any deficiency is recorded as an allowance for credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any amount of unrealized loss that has not been recorded through an allowance for credit loss is recognized in other comprehensive income (loss).

Changes in the allowance for credit loss are recorded as a provision for (or recovery of) credit losses in the Consolidated Statements of Income. Losses are charged against the allowance for credit loss when management believes an available-for-sale security is confirmed to be uncollectible or when either of the criteria regarding intent or requirement to sell is met. At December 31, 2023, there was no allowance for credit loss related to the available-for-sale portfolio.

Accrued interest receivable on available-for-sale securities totaled \$769 thousand at December 31, 2023 and was excluded from the estimate of credit losses.

Allowance for Credit Losses - Loans

The allowance for loan credit losses represents an amount which, in management's judgement, is adequate to absorb the lifetime expected losses that may be sustained on outstanding loans at the balance sheet date based on the evaluation of the size and current risk characteristics of the loan portfolio, past events, current conditions, reasonable and supportable forecasts of future economic conditions, and prepayment experience. The allowance for loan credit losses is measured and recorded upon the initial recognition of a financial asset. The allowance for loan credit losses is reduced by charge-offs, net of recoveries of previous losses, and is increased or decreased by a provision for (or recovery of) credit losses, which is recorded in the Consolidated Statement of Income.

The Company is utilizing a discounted cash flow model to estimate its current expected credit losses. For the purposes of calculating its quantitative reserves, the Company has segmented its loan portfolio based on loans which share similar risk characteristics. Within the quantitative portion of the calculation, the Company utilizes at least one or a combination of loss drivers, which may include unemployment rates, home price indices, and/or gross domestic product ("GDP"), to adjust its loss rates over a reasonable and supportable forecast period of one year. A straight-line reversion technique is used for the following eight quarters, at which time the Company reverts to historical averages. To further adjust the allowance for credit losses for expected losses not already included within the quantitative component of the calculation, the Company may consider qualitative factors, including but not limited to: variability in the economic forecast, changes in volume and severity of adversity classified loans, changes in concentrations of credit, changes in the nature and volume of the loan segments, factors related to credit administration, and other idiosyncratic risks not embedded in the data used in the model.

Loans that do not share risk characteristics are evaluated on an individual basis. The Company designates individually evaluated loans on nonaccrual status as collateral dependent loans, as well as other loans that management of the Company designates as having higher risk and loans for which the repayment is expected to be provided substantially through the operation or sale of the collateral. These loans do not share common risk characteristics and are not included within the collectively evaluated loans for determining the allowance for credit losses. Under CECL, for collateral dependent loans, the Company has adopted the practical expedient to measure the allowance for credit losses based on the fair value of collateral. The allowance for credit losses is calculated on an individual loan basis based on the shortfall between the fair value of the loan's collateral, which is adjusted for liquidation costs/discounts, and amortized cost. If the fair value of the collateral exceeds the amortized cost, no allowance is required.

The adoption of CECL did not result in a significant change to any other credit risk management and monitoring processes, including identification of past due or delinquent borrowers, nonaccrual practices or charge-off policy.

Allowance for Credit Losses – Unfunded Commitments

Financial Instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit issued to meet customer financing needs. The Company's exposure to credit losses in the event of nonperformance by the other party to the financial instrument for off-balance sheet loan commitments is represented by the contractual amount of those instruments. Such financial instruments are recorded when they are funded.

The Company records all allowance for credit losses on off-balance sheet credit exposures, unless the commitments to extend credit are unconditionally cancelable, through a charge to provision for (or recovery of) credit losses in the Consolidated Statement of Income. The allowances for credit losses on off-balance sheet credit exposures is estimated by loan segment at each balance sheet date under the current expected credit losses model using the same methodology as the loan portfolio, taking into consideration the likelihood that funding will occur as well as any third-party guarantees. The allowance for unfunded commitments is included in other liabilities on the Company's consolidated balance sheet.

Accrued Interest Receivable

The Company has elected to exclude the accrued interest from the amortized cost basis in its determination of the allowance for credit losses for both loans and held-to-maturity securities, as well as elected the policy to write-off accrued interest receivable directly through the reversal of interest income. Accrued interest receivable totaled \$3.1 million on loans and \$593 thousand on held-to-maturity securities at September 30, 2023 and is included in "Accrued Interest Receivable" on the Company's Consolidated Balance Sheets.

ASU 2022-01: On January 1, 2023, the Company adopted ASU 2022-01, "Derivatives and Hedging (Topic 815), Fair Value Hedging—Portfolio Layer Method." ASU 2022-01 clarifies the guidance in ASC 815 on fair value hedge accounting of interest rate risk for portfolios of financial assets and is intended to better align hedge accounting with an organization's risk management strategies. In 2017, FASB issued ASU 2017-12 to better align the economic results of risk management activities with hedge accounting. One of the major provisions of that standard was the addition of the last-of-layer hedging method. For a closed portfolio of fixed-rate prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, such as mortgages or mortgage-backed securities, the last-of-layer method allows an entity to hedge its exposure to fair value changes due to changes in interest rates for a portion of the portfolio that is not expected to be affected by prepayments, defaults, and other events affecting the timing and amount of cash flows. ASU 2022-01 renames that method the portfolio layer method. The Company adopted ASU 2022-01 prospectively and it did not have a material impact on its consolidated financial statements.

ASU 2022-02: On January 1, 2023, the Company adopted ASU 2022-02, "Financial Instruments—Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures." ASU 2022-02 addresses areas identified by the FASB as part of its post-implementation review of the credit losses standards (ASU 2016-13) that introduced the CECL model. The amendments eliminate the accounting guidance for troubled debt restructurings (TDRs) by creditors that have adopted the CECL model and enhance the disclosure requirements for certain loan refinancings by creditors when a borrower is experiencing financial difficulty. In addition, the amendments require that the Company disclose current-period gross write-offs for financing receivables and net investment in leases by year of origination in the vintage disclosures. The Company adopted the standard prospectively and it did not have a material impact on the financial statements.

Recent Accounting Pronouncements

In December 2023, the Financial Accounting Standards Board (FASB) issued ASU 2023-09, "Income Taxes (Topic 740): Improvements to Income Tax Disclosures." The amendments in this ASU require an entity to disclose specific categories in the rate reconciliation and provide additional information for reconciling items that meet a quantitative threshold, which is greater than five percent of the amount computed by multiplying pretax income by the entity's applicable statutory rate, on an annual basis. Additionally, the amendments in this ASU require an entity to disclose the amount of income taxes paid (net of refunds received) disaggregated by federal, state, and foreign taxes and the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions that are equal to or greater than five percent of total income taxes paid (net of refunds received). Lastly, the amendments in this ASU require an entity to disclose income (or loss) from continuing operations before income tax expense (or benefit) disaggregated between domestic and foreign and income tax expense (or benefit) from continuing operations disaggregated by federal, state, and foreign. This ASU is effective for annual periods beginning after December 15, 2024. Early adoption is permitted. The amendments should be applied on a prospective basis; however, retrospective application is permitted. The Company does not expect the adoption of ASU 2023-09 to have a material impact on its consolidated financial statements.

In November 2023, the Financial Accounting Standards Board (FASB) issued ASU 2023-07, "Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures." The amendments in this ASU are intended to improve reportable segment disclosure requirements primarily through enhanced disclosures about significant segment expenses. This ASU requires disclosure of significant segment expenses that are regularly provided to the chief operating decision maker (CODM), an amount for other segment items by reportable segment and a description of its composition, all annual disclosures required by FASB ASU Topic 280 in interim

periods as well, and the title and position of the CODM and how the CODM uses the reported measures. Additionally, this ASU requires that at least one of the reported segment profit and loss measures should be the measure that is most consistent with the measurement principles used in an entity's consolidated financial statements. Lastly, this ASU requires public business entities with a single reportable segment to provide all disclosures required by these amendments in this ASU and all existing segment disclosures in Topic 280. This ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted. The amendments should be applied retrospectively. The Company does not expect the adoption of ASU 2023-07 to have a material impact on its consolidated financial statements.

In July 2023, the Financial Accounting Standards Board (FASB) issued ASU 2023-03, "Presentation of Financial Statements (Topic 205), Income Statement—Reporting Comprehensive Income (Topic 220), Distinguishing Liabilities from Equity (Topic 480), Equity (Topic 505), and Compensation—Stock Compensation (Topic 718)". This ASU amends the FASB Accounting Standards Codification for SEC paragraphs pursuant to SEC Staff Accounting Bulletin No. 120, SEC Staff Announcement at the March 24, 2022 EITF Meeting, and Staff Accounting Bulletin Topic 6.B, Accounting Series Release 280—General Revision of Regulation S-X: Income or Loss Applicable to Common Stock. ASU 2023-03 is effective upon addition to the FASB Codification. The Company does not expect the adoption of ASU 2023-03 to have a material impact on its consolidated financial statements.

In March 2023, the FASB issued ASU 2023-02, "Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method". These amendments allow reporting entities to elect to account for qualifying tax equity investments using the proportional amortization method, regardless of the program giving rise to the related income tax credits. The ASU is effective for public business entities for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. The Company does not expect the adoption of ASU 2023-02 to have a material impact on its consolidated financial statements.

In March 2023, the FASB issued ASU 2023-01, "Leases (Topic 842): Common Control Arrangements". These amendments require entities to amortize leasehold improvements associated with common control leases over the useful life to the common control group. The ASU is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted. If an entity adopts the amendments in an interim period, it must adopt them as of the beginning of the fiscal year that includes that interim period. Transition can be done either retrospectively or prospectively. The Company does not expect the adoption of ASU 2023-01 to have a material impact on its consolidated financial statements.

In June 2022, the FASB issued ASU 2022-03, "Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions." ASU 2022-03 clarifies that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. The ASU is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted. The Company does not expect the adoption of ASU 2022-03 to have a material impact on its consolidated financial statements.

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, 2023 and 2022 were as follows (in thousands):

	2023				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value	Allowance for Credit Losses
Securities available for sale:					
U.S. Treasury securities	\$ 12,476	\$ —	\$ (1,026)	\$ 11,450	\$ —
U.S. agency and mortgage-backed securities	96,937	55	(12,192)	84,800	—
Obligations of states and political subdivisions	64,045	6	(7,444)	56,607	—
Total securities available for sale	<u>\$ 173,458</u>	<u>\$ 61</u>	<u>\$ (20,662)</u>	<u>\$ 152,857</u>	<u>\$ —</u>
Securities held to maturity:					
U.S. Treasury securities	\$ 39,085	\$ —	\$ (389)	\$ 38,696	\$ —
U.S. agency and mortgage-backed securities	94,617	—	(8,992)	85,625	—
Obligations of states and political subdivisions	11,649	107	(943)	10,813	—
Corporate debt securities	3,000	—	(520)	2,480	(107)
Total securities held to maturity	<u>\$ 148,351</u>	<u>\$ 107</u>	<u>\$ (10,844)</u>	<u>\$ 137,614</u>	<u>\$ (107)</u>
Total securities	<u>\$ 321,809</u>	<u>\$ 168</u>	<u>\$ (31,506)</u>	<u>\$ 290,471</u>	<u>\$ (107)</u>

	2022			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. Treasury securities	\$ 12,468	\$ —	\$ (1,239)	\$ 11,229
U.S. agency and mortgage-backed securities	109,972	95	(13,149)	96,918
Obligations of states and political subdivisions	64,386	4	(9,630)	54,760
Total securities available for sale	<u>\$ 186,826</u>	<u>\$ 99</u>	<u>\$ (24,018)</u>	<u>\$ 162,907</u>
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	<u>\$ 153,158</u>	<u>\$ —</u>	<u>\$ (11,361)</u>	<u>\$ 141,797</u>
Total securities	<u>\$ 339,984</u>	<u>\$ 99</u>	<u>\$ (35,379)</u>	<u>\$ 304,704</u>

Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position is as follows (in thousands):

	2023					
	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	\$ —	\$ —	\$ 11,450	\$ (1,026)	\$ 11,450	\$ (1,026)
U.S. agency and mortgage-backed securities	1,281	(29)	78,800	(12,163)	80,081	(12,192)
Obligations of states and political subdivisions	4,469	(215)	47,004	(7,229)	51,473	(7,444)
Total securities available for sale	<u>\$ 5,750</u>	<u>\$ (244)</u>	<u>\$ 137,254</u>	<u>\$ (20,418)</u>	<u>\$ 143,004</u>	<u>\$ (20,662)</u>
	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	<u>\$ 61,012</u>	<u>\$ (5,458)</u>	<u>\$ 90,892</u>	<u>\$ (18,560)</u>	<u>\$ 151,904</u>	<u>\$ (24,018)</u>
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	<u>\$ 88,617</u>	<u>\$ (8,466)</u>	<u>\$ 53,181</u>	<u>\$ (2,895)</u>	<u>\$ 141,798</u>	<u>\$ (11,361)</u>
Total securities	<u>\$ 149,629</u>	<u>\$ (13,924)</u>	<u>\$ 144,073</u>	<u>\$ (21,455)</u>	<u>\$ 293,702</u>	<u>\$ (35,379)</u>

The Company has evaluated AFS securities in an unrealized loss position for credit related impairment at December 31, 2023 and 2022 and concluded no impairment existed based on several factors which included: (1) the majority of these securities are of high credit quality, (2) unrealized losses are primarily the result of market volatility and increases in market interest rates, (3) the contractual terms of the investments do not permit the issuer(s) to settle the securities at a price less than the cost basis of each investment, (4) issuers continue to make timely principal and interest payments, and (5) the Company does not intend to sell any of the investments and the accounting standard of “more likely than not” has not been met for the Company to be required to sell any of the investments before recovery of its amortized cost basis.

Additionally, the majority of the Company’s mortgage-backed securities are issued by FNMA, FHLMC, and GNMA and do not have credit risk given the implicit and explicit government guarantees associated with these agencies. In addition, the non-agency mortgage-backed and asset-backed securities generally received a 20% simplified supervisory formula approach rating. The Company’s AFS investment portfolio is generally highly rated or agency backed. At December 31, 2023 and 2022, all AFS securities were current with no securities past due or on non-accrual and no ACL was held against the Company’s AFS securities portfolio. At December 31, 2023, the allowance for credit losses on held to maturity securities was \$107 thousand. There was no allowance for credit losses on held to maturity securities at December 31, 2022.

At December 31, 2023, there were 3 out of 3 U.S. Treasury securities, 93 out of 108 U.S. agency and mortgage-backed securities, 85 out of 99 obligations of states and political subdivisions in an unrealized loss position. One hundred percent of the Company’s investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 5.9 years at December 31, 2023. 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 and 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 was considered investment grade at December 31, 2022. The weighted-average re-pricing term of the portfolio was 6.5 years at December 31, 2022. The unrealized losses at December 31, 2023 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, 2023 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		Amortized	
	Cost	Fair Value	Cost	Fair Value
Due within one year	\$ 760	\$ 758	\$ 30,690	\$ 30,470
Due after one year through five years	23,155	21,736	22,634	21,529
Due after five years through ten years	36,990	33,779	19,830	18,092
Due after ten years	112,553	96,584	75,197	67,523
	<u>\$ 173,458</u>	<u>\$ 152,857</u>	<u>\$ 148,351</u>	<u>\$ 137,614</u>

Proceeds from maturities, calls, principal payments, and sales of securities available for sale during 2023 and 2022 were \$12.5 million and \$39.1 million, respectively. There were no gains or losses realized in 2023. Gross losses of \$2.0 million were realized on calls and sales during 2023.

Proceeds from maturities, calls, and principal payments of securities held to maturity during 2023 and 2022 were \$7.6 million and \$9.3 million, respectively. There were no sales of securities from the held to maturity portfolio for the years ended December 31, 2023 or 2022. The Company did not realize any gross gains or gross losses on held to maturity securities during 2023 or 2022.

Securities having a fair value of \$184.4 million and \$134.5 million at December 31, 2023 and 2022 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 impaired at December 31, 2023, and no impairment has been recognized.

The composition of restricted securities at December 31, 2023 and 2022 was as follows (in thousands):

	2023	2022
Federal Home Loan Bank stock	\$ 965	\$ 796
Federal Reserve Bank stock	981	980
Community Bankers' Bank stock	132	132
	<u>\$ 2,078</u>	<u>\$ 1,908</u>

The Company also holds limited partnership investments in Small Business Investment Companies (SBICs), which are included in other assets in the Consolidated Balance Sheets. The limited partnership investments are measured as equity investments without readily determinable fair values at their cost, less any impairment. The amounts included in other assets for the limited partnership investments were \$642 thousand and \$599 thousand at December 31, 2023 and 2022, respectively.

Credit Quality Indicators & Allowance for Credit Losses - HTM

The Company monitors the credit quality of the debt securities held to maturity through the use of credit ratings from Moody's, S&P, and Egan-Jones. The Company monitors the credit ratings on a quarterly basis. The following table summarizes the amortized cost of debt securities held to maturity at December 31, 2023, and 2022 aggregated by credit quality indicators.

	U.S. Treasury securities	U.S. agency and mortgage- backed securities	Obligations of states and political subdivisions	Corporate debt securities	Total Held to Maturity Securities
December 31, 2023					
Aaa	\$ 39,085	\$ 22,936	\$ 2,807	\$ —	\$ 64,828
Aa1 / Aa2 / Aa3	—	—	8,842	—	8,842
A1 / A2 / A3	—	—	—	—	—
Baa1 / Baa2 / Baa3	—	—	—	3,000	3,000
Not rated - Agency (1)	—	71,681	—	—	71,681
Not rated - Non Agency	—	—	—	—	—
Total	<u>\$ 39,085</u>	<u>\$ 94,617</u>	<u>\$ 11,649</u>	<u>\$ 3,000</u>	<u>\$ 148,351</u>
December 31, 2022					
Aaa	\$ 38,211	\$ 22,706	\$ 3,126	\$ —	\$ 64,043
Aa1 / Aa2 / Aa3	—	—	9,447	—	9,447
Baa1 / Baa2 / Baa3	—	—	—	3,000	3,000
Not rated - Agency (1)	—	76,668	—	—	76,668
Not rated - Non Agency	—	—	—	—	—
Total	<u>\$ 38,211</u>	<u>\$ 99,374</u>	<u>\$ 12,573</u>	<u>\$ 3,000</u>	<u>\$ 153,158</u>

(1) Generally considered not to have credit risk given the implied governmental guarantees associated with these agencies.

The following table summarizes the change in the allowance for credit losses on held to maturity securities for the year ended December 31, 2023.

	U.S. Treasury securities	U.S. agency and mortgage- backed securities	Obligations of states and political subdivisions	Corporate debt securities	Total Held to Maturity Securities
Balance, December 31, 2022	\$ —	\$ —	\$ —	\$ —	\$ —
Adjustment for adoption of ASU 2016-13	—	—	—	134	134
Provision for credit losses	—	—	—	10	10
Charge-offs of securities	—	—	—	—	—
Recoveries	—	—	—	(37)	(37)
Balance, December 31, 2023	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 107</u>	<u>\$ 107</u>

At December 31, 2023, the Company had no securities held-to-maturity that were past due 30 days or more as to principal and interest payments. The Company had no securities held-to-maturity classified as nonaccrual as of December 31, 2023.

Note 3. Loans

Loans at December 31, 2023 and 2022 are summarized as follows (in thousands):

	<u>2023</u>	<u>2022</u>
Real estate loans:		
Construction and land development	\$ 52,680	\$ 51,840
Secured by 1-4 family residential	344,369	331,421
Other real estate	447,272	418,456
Commercial and industrial loans	113,074	111,225
Consumer and other loans	12,035	7,581
Total loans	\$ 969,430	\$ 920,523
Allowance for credit losses	(11,974)	(7,446)
Loans, net	<u>\$ 957,456</u>	<u>\$ 913,077</u>

Net deferred loan fees included in the above loan categories were \$1.1 million and \$838 thousand at December 31, 2023 and 2022, respectively. Net unamortized discounts on loans acquired through business combinations included in the above loan categories totaled \$1.9 million at December 31, 2023 and \$2.5 million at December 31, 2022. Unamortized premiums on loans purchased from a third-party loan originator are included in the commercial and industrial loan categories and totaled \$7.9 million as of December 31, 2023 and \$7.4 million as of December 31, 2022. Consumer and other loans included \$222 thousand and \$197 thousand of demand deposit overdrafts at December 31, 2023 and 2022, respectively.

The following tables provide a summary of loan classes and an aging of past due loans as of December 31, 2023 and 2022 (in thousands):

<u>December 31, 2023</u>								
	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>>90 Days Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Non- Accrual Loans</u>	<u>90 Days or More Past Due and Accruing</u>
Real estate loans:								
Construction and land development	\$ 183	\$ 4	\$ 38	\$ 225	\$ 52,455	\$ 52,680	\$ 38	\$ —
1-4 family residential	1,364	350	392	2,106	342,263	344,369	495	245
Other real estate	—	—	82	82	447,190	447,272	—	82
Commercial and industrial	252	316	197	765	112,309	113,074	6,230	197
Consumer and other loans	33	—	—	33	12,002	12,035	—	—
Total	<u>\$ 1,832</u>	<u>\$ 670</u>	<u>\$ 709</u>	<u>\$ 3,211</u>	<u>\$966,219</u>	<u>\$969,430</u>	<u>\$ 6,763</u>	<u>\$ 524</u>

<u>December 31, 2022</u>								
	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>>90 Days Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Non- Accrual Loans</u>	<u>90 Days or More Past Due and Accruing</u>
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	<u>\$ 1,314</u>	<u>\$ 235</u>	<u>\$ 2,337</u>	<u>\$ 3,886</u>	<u>\$916,637</u>	<u>\$920,523</u>	<u>\$ 2,673</u>	<u>\$ —</u>

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, 2023 and 2022 of loans acquired in business combinations were as follows:

<i>(Dollars in thousands)</i>	Acquired Loans - Purchased Performing	
	2023	2022
Outstanding principal balance	\$ 164,028	\$ 187,017
Carrying amount		
Real estate loans:		
Construction and land development	\$ 7,851	\$ 9,823
Secured by 1-4 family residential	36,290	42,915
Other real estate loans	94,882	103,521
Commercial and industrial loans	19,611	24,661
Consumer and other loans	3,451	3,560
Total acquired loans	<u>\$ 162,085</u>	<u>\$ 184,480</u>

Credit Quality Indicators

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

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

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

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

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

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

The following table presents the Company's recorded investment in loans by credit quality indicators by year of origination as of December 31, 2023 (in thousands).

December 31, 2023

	Term Loans by Year of Origination							
	2023	2022	2021	2020	2019	Prior	Revolving	Total
Construction and land development								
Pass	\$ 2,477	\$ 2,925	\$ 4,350	\$ 3,450	\$ 2,085	\$ 2,859	\$ 34,496	\$ 52,642
Special Mention	—	—	—	—	—	—	—	—
Substandard	—	—	—	—	—	38	—	38
Doubtful	—	—	—	—	—	—	—	—
Total Construction and land development	<u>\$ 2,477</u>	<u>\$ 2,925</u>	<u>\$ 4,350</u>	<u>\$ 3,450</u>	<u>\$ 2,085</u>	<u>\$ 2,897</u>	<u>\$ 34,496</u>	<u>\$ 52,680</u>
Current period gross write-offs	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Secured by 1-4 family residential								
Pass	\$ 43,029	\$ 77,196	\$ 64,063	\$ 41,192	\$ 31,509	\$ 76,295	\$ 10,303	\$ 343,587
Special Mention	—	—	—	—	—	—	—	—
Substandard	—	98	19	—	—	665	—	782
Doubtful	—	—	—	—	—	—	—	—
Total Secured by 1-4 family residential	<u>\$ 43,029</u>	<u>\$ 77,294</u>	<u>\$ 64,082</u>	<u>\$ 41,192</u>	<u>\$ 31,509</u>	<u>\$ 76,960</u>	<u>\$ 10,303</u>	<u>\$ 344,369</u>
Current period gross write-offs	<u>\$ —</u>	<u>\$ 59</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 59</u>
Other real estate loans								
Pass	\$ 51,560	\$ 94,666	\$ 90,089	\$ 41,186	\$ 36,747	\$ 122,755	\$ 10,269	\$ 447,272
Special Mention	—	—	—	—	—	—	—	—
Substandard	—	—	—	—	—	—	—	—
Doubtful	—	—	—	—	—	—	—	—
Total Other real estate loans	<u>\$ 51,560</u>	<u>\$ 94,666</u>	<u>\$ 90,089</u>	<u>\$ 41,186</u>	<u>\$ 36,747</u>	<u>\$ 122,755</u>	<u>\$ 10,269</u>	<u>\$ 447,272</u>
Current period gross write-offs	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 34</u>	<u>\$ —</u>	<u>\$ 34</u>
Commercial and industrial								
Pass	\$ 22,086	\$ 26,755	\$ 20,352	\$ 4,102	\$ 4,448	\$ 8,276	\$ 20,825	\$ 106,844
Special Mention	—	—	—	—	—	—	—	—
Substandard	58	3,757	1,453	—	167	795	—	6,230
Doubtful	—	—	—	—	—	—	—	—
Total Commercial and industrial	<u>\$ 22,144</u>	<u>\$ 30,512</u>	<u>\$ 21,805</u>	<u>\$ 4,102</u>	<u>\$ 4,615</u>	<u>\$ 9,071</u>	<u>\$ 20,825</u>	<u>\$ 113,074</u>
Current period gross write-offs	<u>\$ 315</u>	<u>\$ 1,121</u>	<u>\$ 1,139</u>	<u>\$ 624</u>	<u>\$ —</u>	<u>\$ 253</u>	<u>\$ —</u>	<u>\$ 3,452</u>
Consumer and other loans								
Pass	\$ 3,021	\$ 1,203	\$ 311	\$ 1,471	\$ 2,172	\$ 14	\$ 3,843	\$ 12,035
Special Mention	—	—	—	—	—	—	—	—
Substandard	—	—	—	—	—	—	—	—
Doubtful	—	—	—	—	—	—	—	—
Total Consumer and other loans	<u>\$ 3,021</u>	<u>\$ 1,203</u>	<u>\$ 311</u>	<u>\$ 1,471</u>	<u>\$ 2,172</u>	<u>\$ 14</u>	<u>\$ 3,843</u>	<u>\$ 12,035</u>
Current period gross write-offs	<u>\$ 366</u>	<u>\$ 57</u>	<u>\$ 4</u>	<u>\$ 15</u>	<u>\$ 3</u>	<u>\$ 3</u>	<u>\$ —</u>	<u>\$ 448</u>

The following tables provide an analysis of the credit risk profile of each loan class as of December 31, 2022 (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	<u>\$ 915,590</u>	<u>\$ 1,959</u>	<u>\$ 2,974</u>	<u>\$ —</u>	<u>\$ 920,523</u>

Note 4. Allowance for Credit Losses

The following tables present, as of December 31, 2023 and 2022, the total Allowance for Credit Losses on Loans (ACLL) (previously Allowance for Loan Losses) by portfolio, and information about individually evaluated and collectively evaluated loans (in thousands).

	December 31, 2023					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for credit losses:						
Beginning Balance, December 31, 2022	\$ 546	\$ 1,108	\$ 3,609	\$ 1,874	\$ 309	\$ 7,446
Adjustment to allowance for adoption of ASU 2016-13	(313)	1,409	1,702	(387)	(225)	2,186
Charge-offs	—	(59)	(34)	(3,452)	(448)	(3,993)
Recoveries	—	47	14	145	212	418
Provision for (recovery of) credit losses	79	654	(593)	5,526	251	5,917
Ending Balance, December 31, 2023	<u>\$ 312</u>	<u>\$ 3,159</u>	<u>\$ 4,698</u>	<u>\$ 3,706</u>	<u>\$ 99</u>	<u>\$ 11,974</u>
Ending Balance:						
Individually evaluated	—	—	—	2,705	—	2,705
Collectively evaluated	312	3,159	4,698	1,001	99	9,269
Loans:						
Ending Balance	52,680	344,369	447,272	113,074	12,035	969,430
Individually evaluated	38	495	—	6,230	—	6,763
Collectively evaluated	52,642	343,874	447,272	106,844	12,035	962,667

	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 loan losses	191	18	364	1,043	234	1,850
Ending Balance, December 31, 2022	<u>\$ 546</u>	<u>\$ 1,108</u>	<u>\$ 3,609</u>	<u>\$ 1,874</u>	<u>\$ 309</u>	<u>\$ 7,446</u>
Ending Balance:						
Individually evaluated	—	—	—	888	—	888
Collectively evaluated	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	1,045	530	13	1,085	—	2,673
Collectively evaluated	50,795	330,891	418,443	110,140	7,581	917,850

Nonaccrual loans

The following is a summary of the Company's nonaccrual loans by major categories for the periods indicated (in thousands):

	CECL			Incurring Loss
	December 31, 2023			December 31, 2022
	Nonaccrual Loans with No Allowance	Nonaccrual loans with an Allowance	Total Nonaccrual Loans	Nonaccrual Loans
Real estate loans:				
Construction and land development	\$ 38	\$ —	\$ 38	\$ 1,045
Secured by 1-4 family residential	495	—	495	530
Other real estate loans	—	—	—	13
Commercial and industrial	—	6,230	6,230	1,085
Total	<u>\$ 533</u>	<u>\$ 6,230</u>	<u>\$ 6,763</u>	<u>\$ 2,673</u>

Prior to the adoption of ASU 2016-13, loans were considered impaired when, based on current information and events, it was probable the Company would be unable to collect all amounts due in accordance with the original contractual terms of the loan agreements. Impaired loans included loans on nonaccrual status and accruing troubled debt restructurings. When determining if the Company would be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement, the Company considered the borrower's capacity to pay, which included such factors as the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations and an evaluation of secondary sources of repayment, such as guarantor support and collateral value. The Company individually assessed for impairment all nonaccrual loans and troubled debt restructurings. The tables below include information on all loans deemed impaired. Interest payments on impaired loans were typically applied to principal unless collectability of the principal amount was reasonably assured, in which case interest was recognized on a cash basis.

Impaired loans and the related allowance as of and for the periods ended December 31, 2022 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	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	<u>\$ 4,202</u>	<u>\$ 1,588</u>	<u>\$ 1,085</u>	<u>\$ 2,673</u>	<u>\$ 888</u>	<u>\$ 1,282</u>	<u>\$ 126</u>

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

As of December 31, 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. Modified terms under TDRs included 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.

For the year ended December 31, 2022, there were no TDRs that subsequently defaulted within twelve months of the loan modification. Management defines default as over ninety days past due or the foreclosure and repossession of the collateral or charge-off of the loan during the twelve-month period subsequent to the modification.

There were no non-accrual loans excluded from impaired loan disclosure at December 31, 2023 and December 31, 2022. Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income in the amount of \$223 thousand and \$177 thousand during the years ended December 31, 2023 and 2022, respectively.

Collateral-Dependent Loans

The Company may determine that an individual loan exhibits unique risk characteristics which differentiate it from other loans within our loan pools. In such cases, the loans are evaluated for expected credit losses on an individual basis and excluded from the collective evaluation. Specific allocations of the allowance for credit losses are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. A loan is considered to be collateral dependent when, based upon management's assessment, the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral. In such cases, expected credit losses are based on the fair value of the collateral at the measurement date, adjusted for estimated selling costs if satisfaction of the loan depends on the sale of the collateral. The Company reevaluates the fair value of collateral supporting collateral dependent loans on a quarterly basis. The fair value of real estate collateral supporting collateral dependent loans is evaluated by appraisal services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The underlying collateral can vary based upon the type of loan. The following provides more detail about the types of collateral that secure collateral dependent loans:

- Commercial real estate loans can be secured by either owner occupied commercial real estate or non-owner occupied investment commercial real estate. Typically, owner occupied commercial real estate loans are secured by office buildings, warehouses, manufacturing facilities and other commercial and industrial properties occupied by operating companies. Non-owner occupied commercial real estate loans are generally secured by office buildings and complexes, retail facilities, multifamily complexes, land under development, industrial properties, as well as other commercial or industrial real estate.
- Residential real estate loans are typically secured by first mortgages, and in some cases could be secured by a second mortgage.
- Home equity lines of credit are generally secured by second mortgages on residential real estate property.
- Consumer loans are generally secured by automobiles, motorcycles, recreational vehicles and other personal property. Some consumer loans are unsecured and have no underlying collateral.

The following table presents the amortized cost of collateral-dependent loans (in thousands):

	December 31, 2023		
	Real Estate Secured	Non-Real Estate Secured	Total Collateral-Dependent Loans
<i>(Dollars in thousands)</i>			
Real estate loans:			
Construction and land development	\$ 38	\$ —	\$ 38
Secured by 1-4 family residential	495	—	495
Total	<u>\$ 533</u>	<u>\$ —</u>	<u>\$ 533</u>

At December 31, 2023, no allowance for credit losses was required on collateral-dependent loans.

Modifications Made to Borrowers Experiencing Financial Difficulty

Effective January 1, 2023, the Company refers to loan modifications where the borrower is experiencing financial difficulty and the modification is in the form of principal forgiveness, interest rate reductions, term extensions, other-than-insignificant payment delays, or a combination of the above modifications, as modified loans. The Company accounts for modified loans consistently with its accounting policy for accounting for loan modifications. The ALLL on modified loans is measured using the same method as all other loans held for investment.

The Company evaluates all loan modifications according to the accounting guidance for loan refinancing and restructuring to determine whether the modification should be accounted for as a new loan or a continuation of the existing loan. If the modification meets the criteria to be accounted for as a new loan, any deferred fees and costs remaining prior to the modification are recognized in income and any new deferred fees and costs are recorded on the loan as part of the modification. If the modification does not meet the criteria to be accounted for as a new loan, any new deferred fees and costs resulting from the modification are added to the existing amortized cost basis of the loan.

The Company adopted the accounting guidance in ASU No. 2022-02 on January 1, 2023 that eliminates the recognition and measurement of TDRs. Upon adoption of this guidance, the Company no longer applies its TDR accounting policy and instead accounts for modifications in accordance with its loan modifications policy stated in the preceding paragraphs.

The allowance for credit losses incorporates an estimate of lifetime expected credit losses and is recorded on each asset upon asset origination or acquisition. The starting point for the estimate of the allowance for credit losses is historical loss information, which includes losses from modifications of receivables to borrowers experiencing financial difficulty. The Company uses a probability of default/loss given default model to determine the allowance for credit losses. An assessment of whether a borrower is experiencing financial difficulty is made on the date of a modification.

The effect of most modifications made to borrowers experiencing financial difficulty is already included in the allowance for credit losses because of the measurement methodologies used to estimate the allowance, a change to the allowance for credit losses is generally not recorded upon modification. Occasionally, the Company modifies loans by providing principal forgiveness on certain of its real estate loans. When principal forgiveness is provided, the amortized cost basis of the asset is written off against the allowance for credit losses. The amount of the principal forgiveness is deemed to be uncollectible; therefore, that portion of the loan is written off, resulting in a reduction of the amortized cost basis and a corresponding adjustment to the allowance for credit losses.

In some cases, the Company will modify a certain loan by providing multiple types of concessions. Typically, one type of concession, such as a term extension, is granted initially. If the borrower continues to experience financial difficulty, another concession, such as principal forgiveness, may be granted. For the real estate loans included in the “combination” columns below, multiple types of modifications have been made on the same loan within the current reporting period. The combination is at least two of the following: a term extension, principal forgiveness, and interest rate reduction.

During the year ended December 31, 2023 there were no loans modified to borrowers experiencing financial difficulty.

Upon the Company's determination that a modified loan (or portion of a loan) has subsequently been deemed uncollectible, the loan (or a portion of the loan) is written off. Therefore, the amortized cost basis of the loan is reduced by the uncollectible amount and the allowance for credit losses is adjusted by the same amount. For the year ended December 31, 2023, there were no payment defaults of modified loans that were modified during the previous twelve months.

Unfunded Commitments

The Company maintains a separate reserve for credit losses on off-balance-sheet credit exposures, including unfunded loan commitments, which is included in other liabilities on the consolidated balance sheet. The reserve for credit losses on off-balance-sheet credit exposures is adjusted as a provision for credit losses in the income statement. The estimate includes consideration of the likelihood that funding will occur and an estimate of expected credit losses on commitments expected to be funded over its estimated life, utilizing the same models and approaches for the Company's other loan portfolio segments described in Note 1, as these unfunded commitments share similar risk characteristics as its loan portfolio segments. The Company has identified the unfunded portion of certain lines of credit as unconditionally cancellable credit exposures, meaning the Company can cancel the unfunded commitment at any time. No credit loss estimate is reported for off-balance-sheet credit exposures that are unconditionally cancellable by the Company or for undrawn amounts under such arrangements that may be drawn prior to the cancellation of the arrangement.

On January 1, 2023, the Company recorded an adjustment for unfunded commitments of \$153 thousand for the adoption of ASC Topic 326. For the year ended December 31, 2023, the Company recorded a provision for credit losses for unfunded commitments of \$260 thousand. At December 31, 2023, the liability for credit losses on off-balance-sheet exposures included in other liabilities was \$413 thousand.

Note 5. Other Real Estate Owned

Changes in the balance for OREO during the years ended December 31, 2023 and 2022 are as follows (in thousands):

	2023	2022
Balance at the beginning of year, net	\$ 184	\$ 1,848
Transfers from loans to other real estate owned	—	—
Transfers from property and equipment to other real estate owned	—	184
Acquired in merger	—	—
Sales proceeds	(417)	(2,011)
Gain on disposition	233	176
Balance at the end of year, gross	\$ —	\$ 197
Less: valuation allowance	—	(13)
Balance at the end of year, net	\$ —	\$ 184

There were no residential real estate properties included in the ending OREO balances at December 31, 2023 and 2022. 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, 2023.

Net expenses applicable to OREO, other than the valuation allowance and gain on disposition, were \$10 and \$52 thousand for the years ended December 31, 2023 and 2022, respectively.

Note 6. Premises and Equipment

Premises and equipment are summarized as follows at December 31, 2023 and 2022 (in thousands):

	2023	2022
Land	\$ 5,412	\$ 5,412
Buildings and leasehold improvements	21,145	20,801
Furniture and equipment	8,237	8,081
Construction in process	962	8
	<u>\$ 35,756</u>	<u>\$ 34,302</u>
Less accumulated depreciation	13,614	12,426
Premises and equipment, net	<u>\$ 22,142</u>	<u>\$ 21,876</u>

Depreciation expense included in operating expenses for 2023 and 2022 was \$1.6 million and \$1.5 million, respectively.

Note 7. Deposits

The aggregate amount of time deposits, in denominations of \$250 thousand or more, was \$28.8 million and \$18.8 million at December 31, 2023 and 2022, respectively.

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2023 and 2022, brokered deposits totaled \$3.9 million and \$556 thousand, respectively, and were included in time deposits on the Company's consolidated financial statements.

At December 31, 2023, the scheduled maturities of time deposits were as follows (in thousands):

2024	\$ 134,695
2025	44,530
2026	7,010
2027	3,763
2028	2,351
Thereafter	—
	<u><u>\$ 192,349</u></u>

Note 8. Other Borrowings

The Company had an unsecured line of credit totaling \$5.0 million with a non-affiliated bank at December 31, 2023. There were no borrowings outstanding on the line of credit at December 31, 2023. 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 \$368.2 million and \$287.3 million available with non-affiliated banks at December 31, 2023 and 2022, respectively. These available sources of credit included \$247.7 million available from Federal Home Loan Bank of Atlanta (FHLB), \$69.5 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 16% 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, 2023 and 2022 including real estate loans totaling \$397.4 million and \$286.6 million, respectively, and FHLB stock with a book value of \$965 thousand and \$796 thousand, respectively.

Other borrowings increased \$50.0 million during the year as the Bank borrowed funds in December 2023 from the Federal Reserve Bank through their Bank Term Funding Program. On December 31, 2023, borrowings totaled \$50.0 million with a fixed interest rate of 4.85% and a maturity date of December 26, 2024. The Bank benefited from the borrowing by reducing interest rate risk and increasing net interest income. Other borrowings totaled \$50.0 million at December 31, 2023. The Bank had no other borrowings on December 31, 2022.

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, 2023. 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 \$3 and \$5 thousand at December 31, 2023 and 2022. 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, 2023 and 2022 was 5.64% and 7.34%, 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, 2023 and 2022 was 5.59% and 5.34%, 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 2020.

Net deferred tax assets consisted of the following components at December 31, 2023 and 2022 (in thousands):

	<u>2023</u>	<u>2022</u>
Deferred Tax Assets		
Allowance for credit losses	\$ 2,624	\$ 1,564
Acquisition accounting adjustments, net	420	570
Post-retirement benefits	214	188
Core deposit intangible	232	270
Unvested stock-based compensation	87	81
Reserve for letter of credit losses	44	88
Limited partnership investments	39	39
Lease liability	69	113

Unrealized loss on securities available for sale	5,495	6,536
NOL carryover - acquired from Fincastle	1,337	1,434
Loan origination fees, net	241	176
	<u>\$ 10,802</u>	<u>\$ 11,059</u>

Deferred Tax Liabilities

Depreciation	\$ 638	\$ 701
Right of use asset	69	112
Other real estate owned	—	29
Cash flow hedges	523	563
	<u>\$ 1,230</u>	<u>\$ 1,405</u>
Net deferred tax assets	<u>\$ 9,572</u>	<u>\$ 9,654</u>

The income tax expense for the years ended December 31, 2023 and 2022 consisted of the following (in thousands):

	2023	2022
Current tax expense	\$ 2,580	\$ 4,193
Deferred tax expense (benefit)	(399)	(241)
	<u>\$ 2,181</u>	<u>\$ 3,952</u>

The income tax expense differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2023 and 2022, due to the following (in thousands):

	2023	2022
Computed tax expense at statutory federal rate	\$ 2,479	\$ 4,357
Increase in income taxes resulting from:		
Other	29	8
Decrease in income taxes resulting from:		
Tax-exempt interest and dividend income	(156)	(252)
Income from bank owned life insurance	(171)	(161)
	<u>\$ 2,181</u>	<u>\$ 3,952</u>

Note 12. Funds Restrictions and Reserve Balance

Transfers of funds from the banking subsidiary to the parent company in the form of loans, advances, and cash dividends are restricted by federal and state regulatory authorities. At December 31, 2023, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company, without prior regulatory approval, totaled \$17.1 million. The amount of unrestricted funds is generally determined by subtracting the total dividend payments of the Bank from the Bank's net income for that year, combined with the Bank's retained net income for the preceding two years.

The Bank is typically required to maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. The Federal Reserve adopted a rule in March 2020 eliminating the reserve requirement. There were no required balances at December 31, 2023 or December 31, 2022.

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, 2023 and 2022, expense attributable to the Plan amounted to \$1.2 million and \$1.2 million, 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 \$126 thousand and \$151 thousand for the years ended December 31, 2023 and 2022, respectively, and was solely funded by the Company. The accrued supplemental executive retirement plan liability was \$1.0 million and \$894 thousand at December 31, 2023 and 2022, 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, 2023 and 2022 (dollars in thousands, except per share data):

	<u>2023</u>	<u>2022</u>
(Numerator):		
Net income	\$ 9,624	\$ 16,797
(Denominator):		
Weighted average shares outstanding – basic	6,265,394	6,252,369
Potentially dilutive common shares – restricted stock units	<u>13,711</u>	<u>6,988</u>
Weighted average shares outstanding – diluted	<u>6,279,105</u>	<u>6,259,357</u>
Income per common share		
Basic	\$ 1.54	\$ 2.69
Diluted	\$ 1.53	\$ 2.68

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, 2023 and 2022, the following financial instruments were outstanding whose contract amounts represent credit risk (in thousands):

	<u>2023</u>	<u>2022</u>
Commitments to extend credit and unfunded commitments under lines of credit	\$ 194,242	\$ 158,297
Stand-by letters of credit	11,615	17,950

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

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and may or may not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary.

At December 31, 2023, the Bank had \$1.2 million in locked-rate commitments to originate mortgage loans. There were no loans held for sale at December 31, 2023. 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, 2023 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, 2023 and 2022, these loans totaled \$1.1 million and \$1.1 million, respectively. During 2023, total principal additions were \$133 thousand and total principal payments were \$135 thousand.

Deposits from related parties held by the Bank at December 31, 2023 and 2022 amounted to \$40.5 million and \$27.5 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, 2023 and 2022 (in thousands):

	Classification in the Consolidated Balance Sheets	2023	2022
Operating lease right-of-use asset	Other assets	\$ 328	\$ 535
Operating lease liability	Accrued interest payable and other liabilities	330	537

The following table presents the weighted average remaining operating lease term and the weighted average discount rate for operating leases as of December 31, 2023 and 2022:

	2023	2022
Weighted average remaining lease term, in years	1.7	2.5
Weighted average discount rate	3.69%	3.51%

The following table presents the components of operating lease expense and supplemental cash flow information for the years ended December 31, 2023 and 2022 (in thousands):

	2023	2022
Lease Expense		
Operating lease expense	\$ 257	\$ 247
Short-term lease expense	26	33
Total lease expense (1)	<u>\$ 283</u>	<u>\$ 280</u>
Cash paid for amounts included in lease liability	\$ 240	\$ 249
Right of use assets obtained in exchange for operating lease liabilities commencing during the period	\$ 20	\$ 491

(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, 2023 (in thousands):

Twelve months ending December 31, 2024	\$ 223
Twelve months ending December 31, 2025	99
Twelve months ending December 31, 2026	19
Twelve months ending December 31, 2027	—
Twelve months ending December 31, 2028	—
Total undiscounted cash flows	<u>\$ 341</u>
Less: discount	(11)
Operating lease liability	<u>\$ 330</u>

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

Note 18. Dividend Reinvestment Plan

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

The Company issued 9,214 and 10,384 common shares to the DRIP during the years ended December 31, 2023 and 2022, 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, 2023 and 2022 (in thousands).

<u>Description</u>	Balance as of December 31, 2023	Fair Value Measurements at December 31, 2023		
		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	\$ 11,450	\$ —	\$ 11,450	\$ —
U.S. agency and mortgage-backed securities	84,800	—	84,800	—
Obligations of states and political subdivisions	56,607	—	56,607	—
Total securities available for sale	\$ 152,857	\$ —	\$ 152,857	\$ —
Derivatives - cash flow hedges	2,488	—	2,488	—
Total assets	<u>\$ 155,345</u>	<u>\$ —</u>	<u>\$ 155,345</u>	<u>\$ —</u>

<u>Description</u>	Fair Value Measurements at December 31, 2022			
	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	\$ —

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:

Collateral Dependent Loans with an ACLL

In accordance with ASC 326, the Company may determine that an individual loan exhibits unique risk characteristics which differentiate it from other loans within our loan pools. In such cases, the loans are evaluated for expected credit losses on an individual basis and excluded from the collective evaluation. Specific allocations of the allowance for credit losses are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. A loan is considered to be collateral dependent when, based upon management's assessment, the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral. In such cases, expected credit losses are based on the fair value of the collateral at the measurement date, adjusted for estimated selling costs if satisfaction of the loan depends on the sale of the collateral. We reevaluate the fair value of collateral supporting collateral dependent loans on a quarterly basis. The fair value of real estate collateral supporting collateral dependent loans is evaluated by appraisal services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The allowance for credit losses on collateral dependent loans was \$2.7 million at December 31, 2023.

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, 2023 and 2022.

The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis as of December 31, 2023 and 2022 (dollars in thousands).

<u>Description</u>	Fair Value Measurements at December 31, 2023			
	Balance as of December 31, 2023	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent loans	\$ 533	\$ —	\$ —	\$ 533

Description	Fair Value Measurements at December 31, 2022			
	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

Quantitative information about Level 3 Fair Value Measurements for December 31, 2023

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (1)
Collateral dependent loans	\$ 533	Property appraisals	Selling cost	10.00%

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%

(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, 2023 and 2022 are as follows (in thousands):

	Fair Value Measurements at December 31, 2023 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	\$ 87,161	\$ 87,161	\$ —	\$ —	\$ 87,161
Securities available for sale	152,857	—	152,857	—	152,857
Securities held to maturity, net	148,244	—	137,507	—	137,507
Restricted securities	2,078	—	2,078	—	2,078
Loans, net	957,456	—	—	919,266	919,266
Bank owned life insurance	24,902	—	24,902	—	24,902
Accrued interest receivable	4,655	—	4,655	—	4,655
Derivatives - cash flow hedges	2,488	—	2,488	—	2,488
Financial Liabilities					
Deposits	\$ 1,233,726	\$ —	\$ 1,041,377	\$ 189,354	\$ 1,230,731
FRB borrowings	50,000	—	—	49,987	49,987
Subordinated debt	4,997	—	—	5,412	5,412
Junior subordinated debt	9,279	—	—	8,493	8,493
Accrued interest payable	764	—	764	—	764

		Fair Value Measurements at December 31, 2022 Using			
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
	Carrying Amount				
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

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, 2023 and December 31, 2022, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2023, 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, 2023 and December 31, 2022 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, 2023:						
Total Capital (to Risk-Weighted Assets)	\$ 142,334	14.05%	\$ 81,027	8.00%	\$ 101,284	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 129,840	12.82%	\$ 60,771	6.00%	\$ 81,027	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 129,840	12.82%	\$ 45,578	4.50%	\$ 65,835	6.50%
Tier 1 Capital (to Average Assets)	\$ 129,840	9.31%	\$ 55,797	4.00%	\$ 69,746	5.00%
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%

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, 2023 and December 31, 2022, 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, 2023 and December 31, 2022, 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, 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 \$(1,638))	(6,160)	—	(6,160)
Amortization of unrealized holding losses on available-for-sale securities transferred to held to maturity (net of tax of \$125)	468	—	468
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)
Unrealized holding gains (net of tax, \$697)	2,621	—	2,621
Amortization of unrealized holding losses on available-for-sale securities transferred to held to maturity (net of tax of \$344)	1,295	—	1,295
Change in fair value (net of tax, \$(40))	—	(151)	(151)
Change during period	3,916	(151)	3,765
Balance at December 31, 2023	\$ (20,671)	\$ 1,965	\$ (18,706)

The following table presents information related to reclassifications from accumulated other comprehensive income (loss) for the years ended December 31, 2023 and 2022 (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,		
	2023	2022	
Securities available for sale:			
Net securities losses reclassified into earnings	\$ —	\$ 2,004	Net (losses) on securities available for sale
Related income tax benefit	—	(421)	Income tax benefit
Total reclassifications	\$ —	\$ 1,583	Net of tax

Note 22. Stock Compensation Plans

On May 10, 2023, the Company's shareholders approved the First National Corporation 2023 Stock Incentive Plan, which replaced the 2014 Stock Incentive Plan and makes available up to 325,000 shares of common stock for the granting of stock options, restricted stock awards, restricted stock units, stock appreciation rights, and other stock-based awards. Beginning on May 11, 2023, new equity awards granted by the Company are from the 2023 Stock Incentive Plan and not from the 2014 Stock Incentive Plan. Awards are made at the discretion of the Board of Directors and compensation cost equal to the fair value of the award is recognized over the vesting period.

Stock Awards

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

During 2023, the Company granted and issued 11,700 shares of common stock to members of the Board of Directors for their dedicated service and support. Also during 2023, the Company issued 21,302 shares of common stock to employees. Compensation expense related to stock awards totaled \$402 thousand and \$481 thousand for the years ended December 31, 2023 and 2022, 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 8, 2023, 13,727 restricted stock units were granted to employees with 4,580 units vesting immediately, 4,575 units vesting after one year, and 4,572 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:

	2023	
	Shares	Weighted Average Grant Date Fair Value
Unvested, January 1, 2023	29,181	\$ 20.31
Granted	23,727	16.56
Vested	(11,401)	19.20
Forfeited	—	—
Unvested, December 31, 2023	<u>41,507</u>	<u>\$ 18.47</u>

At December 31, 2023, 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 \$351 thousand. This expense is expected to be recognized through 2028. Compensation expense related to restricted stock unit awards recognized for the years ended December 31, 2023 and 2022 totaled \$351 thousand and \$304 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, 2023 and 2022 net gains/(losses) on sales of foreclosed properties was \$233 and \$176, 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, 2023 and 2022 (in thousands):

	<u>2023</u>	<u>2022</u>
Noninterest Income		
Service charges on deposit accounts	\$ 2,780	\$ 2,677
ATM and check card fees	3,449	3,300
Wealth management fees	3,120	3,008
Brokered mortgage fees	119	245
Fees for other customer services	770	839
Noninterest income (in-scope of Topic 606)	\$ 10,238	\$ 10,069
Noninterest income (out-of-scope of Topic 606)	1,546	2,552
Total noninterest income	<u>\$ 11,784</u>	<u>\$ 12,621</u>

Note 24. Derivative Financial Instruments

On April 21, 2020, the Company entered into two interest rate swap agreements related to its outstanding junior subordinated debt. One swap agreement was related to the Company's junior subordinated debt with a redemption date of June 17, 2034, which became effective on March 17, 2020. The notional amount of the interest rate swap was \$5.0 million and terminates on June 17, 2034. Under the terms of the agreement, the Company pays interest quarterly at a fixed rate of 0.79% and receives interest quarterly at a variable rate of three-month term secured overnight financing rate (SOFR). 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 term SOFR. 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, 2023, 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, 2023 and 2022 (in thousands):

		2023			
		Notional Amount	Assets	Liabilities	Collateral Pledged(1)
Cash Flow Hedges					
Interest rate swap contracts		\$ 9,000	\$ 2,488	\$ —	\$ —
		2022			
		Notional Amount	Assets	Liabilities	Collateral Pledged(1)
Cash Flow Hedges					
Interest rate swap contracts		\$ 9,000	\$ 2,679	\$ —	\$ —

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

Note 25. Subsequent Events

On March 25, 2024, the Company entered into an agreement to acquire Touchstone Bankshares, Inc. (Touchstone) for an aggregate purchase price of \$47.0 million in stock. The financial position and results of operations of Touchstone are not reflected in the Company's financial statements as of December 31, 2023. At the time of closing of the acquisition, Touchstone is expected to have twelve retail bank offices serving south-central Virginia and northern North Carolina, and an administrative office in Prince George, Virginia. The closing of the acquisition is subject to customary closing conditions, including shareholder and regulatory approvals. As of December 31, 2023, Touchstone reported total assets of \$658.7 million, gross loans of \$508.8 million, and total deposits of \$542.2 million.

In connection with the transaction, the Company expects to issue approximately 2.7 million shares of its common stock to the shareholders of Touchstone. Upon completion of the transaction, Touchstone Bank, which is Touchstone's wholly owned banking subsidiary, is expected to be merged with and into First Bank. The acquisition will be accounted for as a business combination under ASC 805, *Business Combinations*. Under acquisition accounting, assets acquired and liabilities assumed are recorded at their acquisition date fair values, and any excess of the purchase price over the aggregate fair value of the net assets acquired is recognized as goodwill.

Note 27. Parent Company Only Financial Statements**FIRST NATIONAL CORPORATION**

(Parent Company Only)

Balance Sheets

December 31, 2023 and 2022

(in thousands)

	<u>2023</u>	<u>2022</u>
Assets		
Cash	\$ 15,572	\$ 9,501
Investment in subsidiaries, at cost, plus undistributed net income	112,317	110,682
Other assets	3,193	3,024
Total assets	<u>\$ 131,082</u>	<u>\$ 123,207</u>
Liabilities and Shareholders' Equity		
Subordinated debt	\$ 4,997	\$ 4,995
Junior subordinated debt	9,279	9,279
Other liabilities	535	573
Total liabilities	<u>\$ 14,811</u>	<u>\$ 14,847</u>
Preferred stock	\$ —	\$ —
Common stock	7,829	7,831
Surplus	32,950	32,716
Retained earnings	94,198	90,284
Accumulated other comprehensive (loss), net	<u>(18,706)</u>	<u>(22,471)</u>
Total shareholders' equity	<u>\$ 116,271</u>	<u>\$ 108,360</u>
Total liabilities and shareholders' equity	<u>\$ 131,082</u>	<u>\$ 123,207</u>

FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Income
Years Ended December 31, 2023 and 2022
(in thousands)

	<u>2023</u>	<u>2022</u>
Income		
Dividends from subsidiary	\$ 11,000	\$ 6,000
Total income	<u>\$ 11,000</u>	<u>\$ 6,000</u>
Expense		
Interest expense	\$ 548	\$ 547
Supplies	1	5
Legal and professional fees	262	209
Data processing	60	47
Management fee-subsiary	369	469
Other expense	85	70
Total expense	<u>\$ 1,325</u>	<u>\$ 1,347</u>
Income before allocated tax benefits and undistributed income of subsidiary	\$ 9,675	\$ 4,653
Allocated income tax benefit	278	283
Income before equity in undistributed income of subsidiary	\$ 9,953	\$ 4,936
Equity in undistributed (loss) income of subsidiary	(328)	11,861
Net income	<u><u>\$ 9,625</u></u>	<u><u>\$ 16,797</u></u>

FIRST NATIONAL CORPORATION
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2023 and 2022
(in thousands)

	<u>2023</u>	<u>2022</u>
Cash Flows from Operating Activities		
Net income	\$ 9,625	\$ 16,797
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of subsidiary	328	(11,861)
Stock-based compensation	753	785
Amortization of debt issuance costs	2	2
(Increase) decrease in other assets	(360)	4,969
Increase (decrease) increase in other liabilities	2	(3)
Net cash provided by operating activities	<u>\$ 10,350</u>	<u>\$ 10,689</u>
Cash Flows from Financing Activities		
Redemption of subordinated debt, net of issuance costs	\$ —	\$ (5,000)
Cash dividends paid on common stock, net of reinvestment	(3,597)	(3,308)
Repurchase of common stock	<u>(682)</u>	<u>(183)</u>
Net cash (used in) financing activities	<u>\$ (4,279)</u>	<u>\$ (8,491)</u>
Increase (decrease) in cash and cash equivalents	\$ 6,071	\$ 2,198
Cash and Cash Equivalents		
Beginning	9,501	7,303
Ending	<u><u>\$ 15,572</u></u>	<u><u>\$ 9,501</u></u>

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, 2023 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, 2023 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

Trading Arrangements

During the three months ended December 31, 2023, none of our directors or officers (as defined in Rule 16a-1(f) of the Exchange Act) informed us of the adoption or termination of any Rule 10b5-1 trading arrangement or non-Rule 10b5-1 trading arrangement (as such terms are defined in Item 408 of Regulation S-K).

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 2024 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, 2023 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).
 - 10.17 First National Corporation 2023 Stock Incentive Plan (incorporated by reference to Appendix A of First National Corporation's proxy statement for the 2023 annual meeting of Shareholders, filed March 31, 2023).
 - 10.18 Form of First National Corporation Restricted Stock Unit Agreement (incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2023).
 - 10.19 Form of First National Corporation Director Stock Award Agreement (incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2023).
 - 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.
- 97.1 Clawback Policy
- 101 The following materials from First National Corporation's Annual Report on Form 10-K for the year ended December 31, 2023 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, 2023, 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 29, 2024

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

<u>/s/ Scott C. Harvard</u> President & Chief Executive Officer Director (principal executive officer)	Date: <u>March 29, 2024</u>
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<u>/s/ M. Shane Bell</u> Executive Vice President & Chief Financial Officer (principal financial officer and principal accounting officer)	Date: <u>March 29, 2024</u>
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<u>/s/ Elizabeth H. Cottrell</u> Chairman of the Board of Directors	Date: <u>March 29, 2024</u>
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<u>/s/ Gerald F. Smith, Jr.</u> Vice Chairman of the Board of Directors	Date: <u>March 29, 2024</u>
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<u>/s/ Jason C. Aikens</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ Emily Marlow Beck</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ Boyce Brannock</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ W. Michael Funk</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ James R. Wilkins, III</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ Kirtesh Patel</u> Director	Date: <u>March 29, 2024</u>
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<u>/s/ George E. Holt, III</u> Director	Date: <u>March 29, 2024</u>
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Subsidiaries of First National Corporation

<u>Name of Subsidiary</u>	<u>State of Organization</u>
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



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), Form S-8 (No. 333-272868) and Form S-8 (No. 333-202022) of First National Corporation of our report dated March 29, 2024, relating to our audit of the consolidated financial statements appearing in the Annual Report on Form 10-K of First National Corporation for the year ended December 31, 2023.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 29, 2024

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, 2023;
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.

Date: March 29, 2024

/s/ Scott C. Harvard

President and Chief Executive Officer

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, 2023;
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.

Date: March 29, 2024

/s/ M. Shane Bell

Executive Vice President and Chief Financial Officer

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, 2023, 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, 2023, 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, 2023, fairly presents, in all material respects, the financial condition and results of operations of First National Corporation.

Date: March 29, 2024

/s/ Scott C. Harvard

President and Chief Executive Officer

**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, 2023, 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, 2023, 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, 2023, fairly presents, in all material respects, the financial condition and results of operations of First National Corporation.

Date: March 29, 2024

/s/ M. Shane Bell

Executive Vice President and Chief Financial Officer

First National Corporation
CLAWBACK POLICY
(Effective August 9, 2023)

Introduction

The Board of Directors (the “**Board**”) of First National Corporation (the “**Company**”) believes that it is in the best interests of the Company and its shareholders to create and maintain a culture that emphasizes integrity and accountability and that reinforces the Company’s pay-for-performance compensation philosophy. The Board has therefore adopted this policy which provides for the recoupment of certain executive compensation in certain events (the “**Policy**”). This Policy is designed to comply with Rule 10D-1 under the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”) and the listing standards of the Nasdaq Stock Market.

The Board will disclose the circumstances of any recoupment required by law or determined by it to be in the best interests of the Company’s shareholders.

Administration

This Policy shall be administered by the Board or, if so designated by the Board, the Compensation and Governance Committee, in which case references herein to the Board shall be deemed references to the Compensation and Governance Committee. Any determinations made by the Board shall be final and binding on all affected individuals.

Covered Executives

This Policy applies to the Company’s current and former executive officers (within the meaning of Rule 10D-1 under the Exchange Act and the listing standards of the Nasdaq Stock Market) (“**Covered Executives**”).

Recoupment; Accounting Restatement

In the event the Company is required to prepare an accounting restatement of its financial statements due to the Company’s material noncompliance with any financial reporting requirement under the securities laws, the Board reasonably promptly will require recoupment of any erroneously awarded Incentive Compensation received by any Covered Executive during the three completed fiscal years immediately preceding the date on which the Company is required to prepare an accounting restatement and such additional periods as may be required under Rule 10D-1 under the Exchange Act or the listing standards of the Nasdaq Stock Market. Recoupment under this Policy will be required on a “no fault” basis, without regard to whether any misconduct occurred or a Covered Executive’s responsibility for the erroneous financial statements.

For purposes of this Policy, an “accounting restatement” includes any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.

Incentive Compensation

For purposes of this Policy, Incentive Compensation means incentive-based compensation (within the meaning of Rule 10D-1 under the Exchange Act and the listing standards of the Nasdaq Stock Market), including, without limitation, any of the following; provided that, such compensation is granted, earned or vested based wholly or in part on the attainment of -one or more financial reporting measures:

- Cash bonuses;
- Other short- and long-term cash awards;
- Stock options;
- Restricted stock;
- Restricted stock units;
- Performance stock units;
- Stock appreciation rights; and
- Other stock-based awards.

Financial reporting measures include any measure that is determined and presented in accordance with the accounting principles used in preparing the Company’s financial statements, or any measure derived wholly or in part from such measures (including non-GAAP financial measures), or the Company’s stock price or total shareholder return.

Excess Incentive Compensation: Amount Subject to Recovery

The amount of erroneously awarded compensation to be recovered will be the excess of the Incentive Compensation received by the Covered Executive based on the erroneous data over the Incentive Compensation that would have been received by the Covered Executive had it been based on the restated amounts, computed without regard to any taxes paid, as determined by the Board.

For Incentive Compensation based on the Company's stock price or total shareholder return, if the Board cannot determine the amount of excess Incentive Compensation received by the Covered Executive directly from the information in the accounting restatement, then it will make its determination based on a reasonable estimate of the effect of the accounting restatement on the Company's stock price or total shareholder return.

Method of Recoupment

The Board will determine, in its sole discretion, the method for recouping Incentive Compensation hereunder, which may include, without limitation:

- requiring reimbursement of cash Incentive Compensation previously paid;
- seeking recovery of any gain realized on the vesting, exercise, settlement, sale, transfer, or other disposition of any equity-based awards;
- offsetting (at the time such compensation would otherwise be payable, to the extent required for compliance with Internal Revenue Code section 409A ("409A")) the recouped amount from any compensation otherwise owed or payable by the Company to the Covered Executive;
- withholding future incentive compensation awards and equity awards;
- cancelling (at a time permissible under 409A, if applicable) outstanding vested or unvested equity awards; and/or
- taking any other remedial and recovery action permitted by law, as determined by the Board.

No Indemnification

The Company shall not indemnify any Covered Executives against the loss of any erroneously awarded Incentive Compensation under this Policy.

Interpretation

The Board is authorized to interpret and construe this Policy and to make all determinations necessary, appropriate or advisable for the administration of this Policy. It is intended that this Policy be interpreted in a manner that is consistent with the requirements of Rule 10D-1 under the Exchange Act and the listing standards of the Nasdaq Stock Market.

Effective Date

This Policy shall be effective as of November 8, 2023 (the "Effective Date") and shall apply to Incentive Compensation that is received by Covered Executives on or after the Effective Date.

Amendment; Termination

The Board may amend this Policy from time to time in its discretion and shall amend this Policy as it deems necessary. The Board may terminate this Policy at any time.

Other Recoupment Rights

The Board intends that this Policy will be applied to the fullest extent of the law. Any right of recoupment under this Policy is in addition to, and not in lieu of, any other remedies or rights of recoupment that may be available to the Company by law or pursuant to the terms of any compensation plan or arrangement, employment agreement, award agreement, or similar agreement.

Impracticability

The Board shall recover any excess Incentive Compensation in accordance with this Policy unless such recovery would be impracticable, as determined by the Compensation Committee in accordance with Rule 10D-1 under the Exchange Act and the listing standards of the Nasdaq Stock Market.

Successors

This Policy shall be binding and enforceable against all Covered Executives and their beneficiaries, heirs, executors, administrators or other legal representatives.

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