

FIRST NATIONAL CORP /VA/
Form 10-Q
May 16, 2011
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2011

or

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

For the transition period from _____ to _____

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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

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

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input checked="" type="checkbox"/>

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 13, 2011, 2,952,303 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

Table of Contents

TABLE OF CONTENTS

		Page
<u>PART I FINANCIAL INFORMATION</u>		
Item 1.	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets</u>	3
	<u>Consolidated Statements of Income</u>	4
	<u>Consolidated Statements of Cash Flows</u>	5
	<u>Consolidated Statements of Changes in Shareholders' Equity</u>	7
	<u>Notes to Consolidated Financial Statements</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	31
Item 4.	<u>Controls and Procedures</u>	32
<u>PART II OTHER INFORMATION</u>		
Item 1.	<u>Legal Proceedings</u>	32
Item 1A.	<u>Risk Factors</u>	32
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
Item 3.	<u>Defaults upon Senior Securities</u>	32
Item 4.	<u>Removed and Reserved</u>	32
Item 5.	<u>Other Information</u>	32
Item 6.	<u>Exhibits</u>	32

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****FIRST NATIONAL CORPORATION****Consolidated Balance Sheets***(in thousands, except share and per share data)*

	(unaudited) March 31, 2011	December 31, 2010
Assets		
Cash and due from banks	\$ 7,329	\$ 5,048
Interest-bearing deposits in banks	14,912	10,949
Federal funds sold	15,000	7,500
Securities available for sale, at fair value	66,660	60,420
Restricted securities, at cost	3,153	3,153
Loans held for sale	150	271
Loans, net of allowance for loan losses, 2011, \$13,168, 2010, \$16,036	413,148	418,994
Other real estate owned, net of valuation allowance, 2011, \$3,026, 2010, \$3,341	5,428	3,961
Premises and equipment, net	20,020	20,302
Interest receivable	1,632	1,667
Other assets	12,803	12,364
Total assets	\$ 560,235	\$ 544,629

Liabilities and Shareholders Equity**Liabilities**

Deposits:		
Noninterest-bearing demand deposits	\$ 82,226	\$ 78,964
Savings and interest-bearing demand deposits	185,076	178,685
Time deposits	210,421	205,851
Total deposits	\$ 477,723	\$ 463,500
Other borrowings	20,117	20,122
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued expenses and other liabilities	3,937	3,230
Commitments and contingencies		
Total liabilities	\$ 511,056	\$ 496,131

Shareholders Equity

Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,160	\$ 14,127
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2011, 2,952,303 shares, 2010, 2,948,901 shares	3,690	3,686

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Surplus	1,614	1,582
Retained earnings	29,454	28,969
Accumulated other comprehensive income, net	261	134
Total shareholders' equity	\$ 49,179	\$ 48,498
Total liabilities and shareholders' equity	\$ 560,235	\$ 544,629

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Income**

Three months ended March 31, 2011 and 2010

(in thousands, except per share data)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Interest and Dividend Income		
Interest and fees on loans	\$ 5,833	\$ 6,260
Interest on federal funds sold	7	
Interest on deposits in banks	7	2
Interest and dividends on securities available for sale:		
Taxable interest	451	468
Tax-exempt interest	123	145
Dividends	17	12
Total interest and dividend income	\$ 6,438	\$ 6,887
Interest Expense		
Interest on deposits	\$ 1,303	\$ 1,676
Interest on federal funds purchased		5
Interest on company obligated mandatorily redeemable capital securities	109	108
Interest on other borrowings	91	149
Total interest expense	\$ 1,503	\$ 1,938
Net interest income	\$ 4,935	\$ 4,949
Provision for loan losses	270	411
Net interest income after provision for loan losses	\$ 4,665	\$ 4,538
Noninterest Income		
Service charges on deposit accounts	\$ 501	\$ 609
ATM and check card fees	371	314
Trust and investment advisory fees	342	310
Fees for other customer services	73	73
Gains on sale of loans	47	40
Gains on sale of securities available for sale		2
Net losses on sale of other real estate owned		(52)
Other operating income	6	25
Total noninterest income	\$ 1,340	\$ 1,321

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Noninterest Expense		
Salaries and employee benefits	\$ 2,288	\$ 2,227
Occupancy	341	344
Equipment	325	348
Marketing	105	124
Stationery and supplies	79	97
Legal and professional fees	201	226
ATM and check card fees	171	177
FDIC assessment	190	187
Bank franchise tax	105	100
Provision for other real estate owned	130	
Other real estate owned expense	126	66
Telecommunications expense	90	64
Other operating expense	404	437
Total noninterest expense	\$ 4,555	\$ 4,397
Income before income taxes	\$ 1,450	\$ 1,462
Income tax provision	447	447
Net income	\$ 1,003	\$ 1,015
Effective dividend on preferred stock	223	221
Net income available to common shareholders	\$ 780	\$ 794
Earnings per common share, basic and diluted	\$ 0.26	\$ 0.27

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Cash Flows**

Three months ended March 31, 2011 and 2010

(in thousands)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Cash Flows from Operating Activities		
Net income	\$ 1,003	\$ 1,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	298	318
Origination of loans held for sale	(3,170)	(2,838)
Proceeds from sale of loans held for sale	3,338	2,963
Gains on sale of loans held for sale	(47)	(40)
Provision for loan losses	270	411
Provision for other real estate owned	130	
Gains on sale of securities available for sale, net		(2)
Losses on sale of other real estate owned, net		52
Accretion of security discounts	(10)	(10)
Amortization of security premiums	114	92
Shares acquired by leveraged ESOP		34
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	35	(10)
Increase in other assets	(439)	(148)
Increase (decrease) in accrued expenses and other liabilities	542	(527)
Net cash provided by operating activities	\$ 2,064	\$ 1,310
Cash Flows from Investing Activities		
Proceeds from maturities, calls, and principal payments of securities available for sale	\$ 2,733	\$ 2,679
Purchase of securities available for sale	(8,885)	
Increase in federal funds sold	(7,500)	(2,220)
Purchase of premises and equipment	(16)	(37)
Proceeds from sale of other real estate owned	182	756
Net (increase) decrease in loans	3,897	(626)
Net cash used in investing activities	\$ (9,589)	\$ (552)
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$ 9,653	\$ 4,043
Net increase (decrease) in time deposits	4,570	(11,782)
Proceeds from other borrowings	10,000	23,600
Principal payments on other borrowings	(10,005)	(23,639)
Cash dividends paid on common stock	(259)	(356)

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Cash dividends paid on preferred stock	(190)	(190)
Shares issued to leveraged ESOP		(26)
Net cash provided by (used in) financing activities	\$ 13,769	\$ (8,350)
Increase (decrease) in cash and cash equivalents	\$ 6,244	\$ (6,488)
Cash and Cash Equivalents		
Beginning	\$ 15,997	\$ 14,977
Ending	\$ 22,241	\$ 8,489

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Cash Flows**

(Continued)

Three months ended March 31, 2011 and 2010

(in thousands)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 1,514	\$ 2,028
Income taxes	\$	\$ 1,446
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gain on securities available for sale	\$ 192	\$ 294
Transfer from loans to other real estate owned	\$ 2,292	\$ 1,101
Loan originated from sale of other real estate owned	\$ 640	\$
Issuance of common stock, dividend reinvestment plan	\$ 36	\$ 54

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Changes in Shareholders' Equity**

Three months ended March 31, 2011 and 2010

*(in thousands, except share and per share data)**(unaudited)*

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2009	\$ 13,998	\$ 3,664	\$ 1,418	\$ 35,104	\$ (42)	\$ 665		\$ 54,807
Comprehensive income:								
Net income				1,015			\$ 1,015	1,015
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, \$101)							195	
Reclassification adjustment (net of tax, \$1)							(1)	
Other comprehensive income (net of tax, \$100)						194	\$ 194	194
Total comprehensive income							\$ 1,209	
Shares acquired by leveraged ESOP				(26)	34			8
Cash dividends on common stock (\$0.14 per share)				(410)				(410)
Issuance of 5,210 shares common stock, dividend reinvestment plan		7	47					54
Cash dividends on preferred stock				(190)				(190)
Accretion on preferred stock discount	31			(31)				
Balance, March 31, 2010	\$ 14,029	\$ 3,671	\$ 1,439	\$ 35,488	\$ (8)	\$ 859		\$ 55,478

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2010	\$ 14,127	\$ 3,686	\$ 1,582	\$ 28,969	\$	\$ 134		\$ 48,498
Comprehensive income:								
Net income				1,003			\$ 1,003	1,003

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Other comprehensive income, net of tax:

Unrealized holding gains arising during the period (net of tax, \$65)						127	127	127
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Total comprehensive income							\$	1,130
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Cash dividends on common stock (\$0.10 per share)						(295)		(295)
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Issuance of 3,402 shares common stock, dividend reinvestment plan			4	32				36
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Cash dividends on preferred stock						(190)		(190)
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Accretion on preferred stock discount		33				(33)		
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Balance, March 31, 2011		\$ 14,160	\$ 3,690	\$ 1,614	\$ 29,454	\$	\$	261	\$ 49,179
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See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at March 31, 2011 and December 31, 2010, the results of operations for the three months ended March 31, 2011 and 2010 and cash flows and changes in shareholders' equity for the three months ended March 31, 2011 and 2010. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2010. Operating results for the three month period ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and restricted securities. Restricted securities include required equity investments in certain correspondent banks which have no readily determinable market value. Amortized costs and fair values of securities available for sale at March 31, 2011 and December 31, 2010 were as follows:

	<i>(in thousands)</i>			
	March 31, 2011			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 51,904	\$ 1,475	\$ (153)	\$ 53,226
Obligations of states and political subdivisions	13,061	338	(153)	13,246
Corporate equity securities	23	165		188
	\$ 64,988	\$ 1,978	\$ (306)	\$ 66,660

	<i>(in thousands)</i>			
	December 31, 2010			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 45,627	\$ 1,508	\$ (211)	\$ 46,924
Obligations of states and political subdivisions	13,290	225	(214)	13,301
Corporate equity securities	23	172		195
	\$ 58,940	\$ 1,905	\$ (425)	\$ 60,420

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At March 31, 2011 and December 31, 2010, investments in an unrealized loss position that were temporarily impaired were as follows:

(in thousands)

	Less than 12 months		March 31, 2011 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 13,004	\$ (153)	\$	\$	\$ 13,004	\$ (153)
Obligations of states and political subdivisions	1,300	(104)	929	(49)	2,229	(153)
	\$ 14,304	\$ (257)	\$ 929	\$ (49)	\$ 15,233	\$ (306)

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)*

	<i>(in thousands)</i>					
	Less than 12 months		December 31, 2010 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 11,286	\$ (211)	\$	\$	\$ 11,286	\$ (211)
Obligations of states and political subdivisions	2,923	(128)	893	(86)	3,816	(214)
	\$ 14,209	\$ (339)	\$ 893	\$ (86)	\$ 15,102	\$ (425)

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

At March 31, 2011, there were eight U.S. agency and mortgage-backed securities and four obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.8 years at March 31, 2011.

The Company's investment in FHLB stock totaled \$2.3 million at March 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at March 31, 2011, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.

Note 3. Loans

Loans at March 31, 2011 and December 31, 2010 are summarized as follows:

	<i>(in thousands)</i>	
	March 31, 2011	December 31, 2010
Real estate loans:		
Construction	\$ 50,655	\$ 52,591
Secured by 1-4 family residential	120,863	121,506
Other real estate loans	202,208	207,371
Commercial and industrial loans	39,659	40,683
Consumer loans	12,931	12,879
Total loans	\$ 426,316	\$ 435,030

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Allowance for loan losses	13,168	16,036
Loans, net	\$ 413,148	\$ 418,994

Consumer loans included \$128 thousand and \$231 thousand of demand deposit overdrafts at March 31, 2011 and December 31, 2010, respectively.

The Company has a credit concentration of loans secured by real estate. These loans totaled \$373.7 million, or 88% of total loans, and \$381.5 million, or 88% of total loans, at March 31, 2011 and December 31, 2010, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be impacted by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$42.5 million at March 31, 2011, representing 86% of total equity and 10% of total loans. At December 31, 2010, this concentration totaled \$41.6 million representing 86% of total equity and 10% of total loans. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this concentration of credit risk during the three month period ended March 31, 2011 and charged down \$147 thousand related to these loans during the year ended December 31, 2010.

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)*

The following table provides a summary of loan classes and an aging of past due loans as of March 31, 2011 and December 31, 2010:

	March 31, 2011 <i>(in thousands)</i>							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	\$ 555	\$ 190	\$ 3,345	\$ 4,090	\$ 46,565	\$ 50,655	\$ 3,172	\$ 173
1-4 family residential	2,014	440	74	2,528	118,335	120,863	784	
Other real estate loans	1,535	551	6,202	8,288	193,920	202,208	7,032	1,481
Commercial and industrial	689	504		1,193	38,466	39,659	23	
Consumer	85	16	5	106	12,825	12,931	5	
Total	\$ 4,878	\$ 1,701	\$ 9,626	\$ 16,205	\$ 410,111	\$ 426,316	\$ 11,016	\$ 1,654

	December 31, 2010 <i>(in thousands)</i>							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	\$ 525	\$	\$ 3,665	\$ 4,190	\$ 48,401	\$ 52,591	\$ 5,780	\$
1-4 family residential	2,642	178	315	3,135	118,371	121,506	628	315
Other real estate loans	10,225	3,475	751	14,451	192,920	207,371	4,407	283
Commercial and industrial	1,033	3		1,036	39,647	40,683		
Consumer	168	10	1	179	12,700	12,879	2	
Total	\$ 14,593	\$ 3,666	\$ 4,732	\$ 22,991	\$ 412,039	\$ 435,030	\$ 10,817	\$ 598

Credit Quality Indicators

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

The Company utilizes a risk grading matrix to assign a rating to each of its loans. The loan ratings are summarized into the following categories: pass, special mention, substandard, doubtful and loss. Pass rated loans include all risk rated credits other than those included in special mention,

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substandard or doubtful. Loans classified as loss are charged-off. Loan officers assign risk grades to loans at origination and as renewals arise. The Bank's Credit Administration department reviews risk grades for accuracy on a quarterly basis and as delinquency issues arise. In addition, a certain amount of loans are reviewed each year through the Company's internal and external loan review process. A description of the general characteristics of the loan grading categories is as follows:

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

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

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

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)*

The following tables provide an analysis of the credit risk profile of each loan class as of March 31, 2011 and December 31, 2010:

	March 31, 2011 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
Real estate loans:					
Construction	\$ 20,546	\$ 8,453	\$ 19,588	\$ 2,068	\$ 50,655
Secured by 1-4 family residential	103,939	5,573	11,183	168	120,863
Other real estate loans	145,160	13,617	38,649	4,782	202,208
Commercial and industrial	33,879	4,004	1,753	23	39,659
Consumer	12,840	85	6		12,931
Total	\$ 316,364	\$ 31,732	\$ 71,179	\$ 7,041	\$ 426,316

	December 31, 2010 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
Real estate loans:					
Construction	\$ 21,212	\$ 5,237	\$ 21,471	\$ 4,671	\$ 52,591
Secured by 1-4 family residential	106,722	4,435	10,349		121,506
Other real estate loans	143,874	17,915	43,443	2,139	