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FIRST NATIONAL CORP /VA/
Form 10KSB
March 31, 2003

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002
Commission file number 0-23976

FIRST NATIONAL CORPORATION
(Name of Small Business Issuer 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)

(540) 465-9121
(Issuer's Telephone Number, Including Area Code)

Securities registered under Section 12(b) of the Exchange Act:

| Title of Each Class ----- | Name of Each Exchange on Which Registered ----- |
|------------------------------|-------------------------------------------------------|
| None | n/a |

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, par value \$5.00 per share
(Title of Class)

Check whether the issuer: (1) filed all reports required to be filed by
Section 13 or 15(d) of the Exchange Act during the past 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 past 90 days.

Yes X No

Check if there is no disclosure of delinquent filers in response to
Item 405 of Regulation S-B contained in this form, and no disclosure will be
contained, to the best of registrant's knowledge, in definitive proxy or
information statements incorporated by reference in Part III of this Form 10-KSB
or any amendment to this Form 10-KSB. [X]

The issuer's gross income for its most recent fiscal year was
\$19,602,734.

The aggregate market value of the voting stock held by non-affiliates
computed by reference to the closing sales price of such stock on February 28,
2003 was approximately \$32,165,364. (The exclusion from such amount of the
market value of the shares owned by any person shall not be deemed an admission
by the registrant that such person is an affiliate of the registrant.)

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The number of outstanding shares of Common Stock as of February 28, 2003 was 731,031.

DOCUMENTS INCORPORATED BY REFERENCE

2002 Annual Report to Shareholders - Part II
Proxy Statement for the 2003 Annual Meeting of Shareholders - Part III

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Part I

Item 1. Description of Business

The Corporation

First National Corporation (the "Corporation") was organized on September 7, 1983 as a Virginia corporation for the purpose of acquiring all of the outstanding common stock of the First National Bank of Strasburg (effective June 1, 1994, name changed to First Bank) (the "Bank") in connection with the reorganization of the Bank into a one bank holding company structure. At the effective date of the reorganization, the Bank merged into a newly-formed state bank organized as a wholly-owned subsidiary of the Corporation, with each outstanding share of common stock of the Bank being converted into one share of common stock of the Corporation. The primary activity of the Corporation is the ownership and operation of the Bank.

The Bank

The bank is currently organized as a state chartered bank under the laws of the Commonwealth of Virginia. It commenced operations on July 1, 1907 as The Peoples National Bank of Strasburg. On January 10, 1928 the Bank changed its name to the First National Bank of Strasburg and moved into its current headquarters location in Strasburg.

On July 8, 1985, the Bank's first branch was opened in the town of Front Royal, Virginia. The second branch was opened on July 26, 1985 in the City of Winchester, Virginia. The Bank purchased a branch in Frederick County, Virginia from First Union National Bank of Virginia on March 31, 1994. The Bank opened this former First Union branch as a full service office on July 1, 1994. A fourth branch was constructed in the town of Woodstock, Virginia and opened for business on May 30, 1995. During 1998, two additional office locations were opened. The Bank leased office space for a Loan Production Office in downtown Winchester, Virginia, which opened on March 18, 1998. Additionally, a new full-service branch facility was purchased on the north side of Winchester, Virginia. This location was opened for business on December 19, 1998. The Bank opened a sixth branch on June 28, 1999 with the lease of a former Regional Bank branch office in Woodstock, Virginia. In June of 2002, the bank opened a branch on Shenandoah Avenue in Front Royal, Virginia.

On April 12, 1994, the Bank received approval from the Federal Reserve Bank of Richmond (the "Federal Reserve") and the Virginia State Corporation Commission's Bureau of Financial Institutions (the "SCC") to convert to a state chartered bank with membership in the Federal Reserve System. The Bank was given one year from approval to convert. On June 1, 1994, the Bank consummated such conversion and changed its name to First Bank.

In April 1994, the Bank formed a subsidiary, First Bank Financial Services, Inc. ("Financial Services"), for the purpose of investing in Bankers Title of Fredericksburg, LLC, a title insurance company formed by a group of community banks in Virginia. This company underwrites title insurance which is sold through the banks which own the company.

Banking Services

As a full-service commercial bank, the Bank provides a wide range of deposit, loan and other general banking services to individuals, businesses, institutions and government entities. The Bank's deposit services for individuals include checking, statement savings, NOW accounts, money market accounts, IRA deposits, certificates of deposit, Christmas club accounts, direct deposit programs, a club account, life-line checking accounts and investment

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savings accounts. Loan services to individuals include personal and installment loans (including automobile and property improvement loans), residential mortgages, adjustable rate mortgages, bi-weekly mortgages, home equity loans, and MasterCard and Visa credit cards. The Bank also offers consumers other general banking services, such as safe deposit facilities, travelers checks and collections, and acts as agent for the purchase and redemption of United States Savings Bonds. In addition, the Bank offers corporate and business services, including regular business checking, corporate savings, certificates of deposit, commercial and small business loans, and on-line wire transfer services. The Bank also offers Commercial mortgages. During 1999 the bank began to

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offer equipment leasing services and a wider array of mortgage products. In 2000 the bank introduced an on-line banking package including bill-payer to be fully integrated with our enhanced website (www.firstbank-va.com). During 2002, the bank introduced "free community checking" and "premium interest checking". These accounts have been some of our most successful checking account programs and have generated a large part of the \$9.7 million increase in noninterest-bearing demand deposits and \$26.7 million increase in savings and interest-bearing demand deposits.

Location and Service

The Bank serves the areas of Shenandoah, Frederick, Warren and Clarke Counties and the City of Winchester in Virginia. The Bank solicits business from individuals and small to medium-sized businesses, including retail shops and professional service businesses, residing in this service area.

The Bank has offices at the following locations:

Main Office - 112 W. King St., Strasburg, Virginia

Front Royal Express Office - 508 N. Commerce Ave., Front Royal, Virginia

Winchester Office - 2210 Valley Ave., Winchester, Virginia

Kernstown Office - 3143 Valley Pike, Winchester, Virginia

Remote ATM site at Strasburg Square Shopping Center, Strasburg, Virginia

Woodstock South Office - 860 South Main Street, Woodstock, Virginia

Remote ATM site at Judd's Inc., Strasburg, Virginia

N. Loudoun Street Office - 661 N. Loudoun Street, Winchester, Virginia

Winchester LPO - 9 W. Piccadilly Street, Winchester, Virginia

Remote ATM site at Apple Mountain Chevron, Linden, Virginia

Woodstock North Office - 496 N. Main Street, Woodstock, Virginia

Four remote ATM sites at Handy-Marts, Winchester, Virginia

Two remote ATM sites at Handy-Marts, Woodstock, Virginia

Front Royal Office - 1717 Shenandoah Avenue, Front Royal, Virginia

Remote ATM site at Bryce Resort, Basye, Virginia

Remote ATM site at Short Stop Chevron, New Market, Virginia

Competition

The Bank is subject to intense competition from various financial institutions and other companies or firms that offer financial services. In its market area, the Corporation is and will be competing with several state-wide and regional banking institutions. The Bank competes for deposits with other commercial banks, savings and loan associations, credit unions and with issuers of commercial paper and securities, such as money market and mutual funds. In making loans, the Bank competes with other commercial banks, savings and loan associations, consumer finance companies, credit unions, leasing companies and other lenders.

Federal and state legislative changes since 1982 have significantly

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increased competition among financial institutions, and current trends toward further deregulation may be expected to increase such competition even further. Many of the financial organizations in competition with the Corporation have greater financial resources than the Corporation and are able to offer similar services at varying costs with greater loan capacities. Of all the banks in our marketplace, the Bank is one of a few that serves the area exclusively as an independent, community bank. This enables it to identify and meet customer needs efficiently and enhance its competitiveness in the marketplace. The Bank's history, dating back to 1907, also allows it to compete from a position of strength and stability.

Asset and Liability Management

Assets of the Bank consist primarily of loans and its investment portfolio. Deposit accounts, including checking accounts and interest-bearing accounts, time deposits and certificates of deposit, represent the majority of the liabilities of the Bank. In an effort to maintain adequate levels of liquidity and minimize fluctuations in the net

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interest margin (net interest earnings divided by total interest-earning assets), the rate sensitivity of the loan and investment portfolios are similar to the rate sensitivity of the Bank's liabilities.

The Bank invests the majority of its investment portfolio in highly marketable short-term assets, such as federal funds and issues of the United States government and its agencies. By pricing loans on a variable rate structure, or by keeping the maturity of the investment and loan portfolios relatively short-term, the Bank is able to maintain loan interest or to reinvest securities proceeds at prevailing market rates, thereby helping to maintain a generally consistent spread over the interest rates paid by the Bank on the deposits which are used to fund the investment and loan portfolios.

Lending Activities

The Bank is an active lender with a loan portfolio that includes commercial and residential mortgages, real estate construction loans, commercial loans, and consumer loans. The Corporation's lending activity extends to individuals and small and medium-sized businesses within its primary service area. Consistent with its focus on providing community-based financial services, the Bank does not attempt to diversify its loan portfolio geographically by making significant amounts of loans to borrowers outside of its primary service area.

The principal economic risk associated with each of the categories of loans in the portfolio is the credit worthiness of its borrowers. Within each category, such risk is increased or decreased depending on prevailing economic conditions. In an effort to manage this risk, it is the Bank's policy to give loan amount approval limits to individual loan officers based on their level of experience. The risk associated with the real estate mortgage loans and installment loans to individuals varies based upon employment levels, consumer confidence, fluctuations in the value of residential real estate and other conditions that affect the ability of consumers to repay indebtedness. The risk associated with commercial, financial and agricultural loans varies based upon the strength and activity of the local economies of the Bank's market area. The risk associated with real estate construction loans varies based upon the supply and demand for the type of real estate under construction. Most of the Bank's real estate construction loans are for pre-sold or contract homes.

Residential Mortgage Lending. Residential mortgage loans are made in

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amounts up to 80% (95% with Mortgage Guaranty Insurance) of the appraised value of the security property. Residential mortgage loans are underwritten using qualification guidelines. The Bank requires that the borrower obtain title, fire and casualty coverage in an amount equal to the loan amount and in a form acceptable to the Bank.

The Bank charges origination fees on its residential mortgage loans. These fees vary among loan products and with market conditions. Generally such fees amount to 1.0% to 2.125% of the loan principal amount. In addition, the Bank charges fees to its borrowers to cover the cost of appraisals, credit reports and certain expenses related to the documentation and closing of loans.

Real Estate Construction Loans. The Bank does originate construction loans on income-producing properties such as apartments, shopping centers, hotels and office buildings. These loans are carefully underwritten with emphasis placed on the project income, as well as, the borrowers and guarantors ability to repay from outside sources. The Bank also makes construction loans for residential purposes. These loans are primarily used for construction of owner-occupied residential homes and are considered an attractive type of lending due to their short-term maturities and high yields. The Bank does not participate in any "speculative lending" which relies on market demand after construction.

Construction lending entails significant additional risk as compared with commercial and residential mortgage lending. Construction loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of the home under construction, which is of uncertain value prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To minimize risks associated with construction lending, the Bank limits loan amounts to 80% of appraised value on pre-sold homes in addition to its usual credit analysis of its borrowers. The Bank also obtains a first lien on the security property as security for its construction loans.

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Commercial Real Estate Lending. The Bank provides permanent mortgage financing for a variety of commercial projects. These loans are written with maturities generally within one and five years and are made predominantly on an adjustable rate basis. The Bank attempts to concentrate its commercial real estate lending efforts into owner-occupied projects. However, from time to time, in the normal course of business, the Bank will provide a limited amount of financing for income producing, non-owner occupied projects which meet all of the guidelines established by loan policy.

Commercial Loans. As a full-service community bank, the Bank makes loans to qualified small businesses in its service area. Commercial business loans generally have a higher degree of risk than commercial and residential mortgage loans but have commensurately higher yields. To manage these risks, the Bank secures appropriate collateral and carefully monitors the financial condition of its business borrowers. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of its business and are either 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 may be substantially dependent on the success of the business itself. Further, the collateral for secured commercial business loans may depreciate over time and cannot be appraised with as much precision as real estate.

Consumer Loans. The Bank currently offers most types of consumer

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demand, time and installment loans including automobile loans and home equity lines of credit. The risk associated with installment loans to individuals varies based upon employment levels, consumer confidence, and other conditions that affect the ability of consumers to repay indebtedness.

Employees

At December 31, 2002, a total of 93 persons were employed by the Corporation and the Bank in both full and part time positions. None are represented by any collective bargaining unit. The Corporation considers relations with its employees to be good.

Supervision and Regulation

General. As a bank holding company registered under the Bank Holding Company Act of 1956 (the "BHCA"), the Corporation is subject to the supervision and examination of the Board of Governors of the Federal Reserve System and is required to file with the Federal Reserve such reports and other information as the Federal Reserve may require. The Bank was supervised and regularly examined by the Office of the Comptroller of the Currency, but upon its conversion to a state chartered bank on June 1, 1994, became subject to the oversight of the Federal Reserve and the Bureau of Financial Institutions of the Virginia State Corporation Commission (the "SCC"). The various laws and regulations administered by the regulatory agencies affect corporate practices, such as dividend payments, incurring debt, acquisition of financial institutions and other companies, and types of business conducted.

Bank Holding Company Regulation. Under Federal Reserve policy, a bank holding company is expected to act as a source of financial strength to each of its subsidiary banks and to commit resources to support such banks in circumstances where it might not do so absent such policy. The BHCA requires a bank holding company to obtain Federal Reserve approval before it acquires, directly or indirectly, ownership or control of any voting shares of a bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls a majority of such voting shares). Federal Reserve approval also must be obtained before a bank holding company acquires all or substantially all of the assets of another bank or bank holding company or merges or consolidates with another bank holding company. In addition to the approval of the Federal Reserve, before any bank acquisition can be completed, prior approval thereof must be obtained from each other banking agency which has supervisory jurisdiction over the bank to be acquired.

The BHCA also prohibits a bank holding company, with certain limited exceptions, from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank, or from engaging in any activities other than those of banking or of managing or controlling banks or furnishing services to or performing services for its subsidiaries. The principal exceptions to these prohibitions

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permit a bank holding company to engage in, or acquire an interest in a company that engages in activities which, after due notice and opportunity for hearing, the Federal Reserve by regulation or order has determined are so closely related to banking or of managing or controlling banks as to be a proper incident thereto.

The subsidiary banks of a bank holding company are subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or any of its subsidiaries, or investments in the stock or other securities thereof, and on the taking of such stocks or securities as

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collateral for loans. The Federal Reserve possesses cease and desist powers over bank holding companies if their actions represent unsafe or unsound practices or violations of law.

A bank holding company may not, without providing prior notice to the Federal Reserve, purchase or redeem its own stock if after the transaction the company is no longer classified as "well-capitalized."

The Corporation is also subject to certain provisions of Virginia law that affect the ability of a bank holding company to acquire another financial institution based in Virginia. Under certain amendments to the Virginia Financial Institutions Holding Company Act that became effective July 1, 1983, no corporation, partnership or other business entity may acquire, or make any public offer to acquire, more than 5% of the stock of any Virginia financial institution or any Virginia financial institution holding company, unless it shall first file an application with the SCC. The SCC is directed by the statute to solicit the views of the affected financial institution, or financial institution holding company, with respect to such stock acquisition, and is empowered to conduct an investigation during the 60 days following receipt of such an application. If the SCC takes no action within the prescribed period, or if during the prescribed period it issues notice of its intent not to disapprove an application, the acquisition may be completed. The SCC may disapprove an application subject to such conditions as it may deem advisable.

The Bank. As stated earlier in this item under "The Bank," the Bank received approval from the Federal Reserve and the SCC and converted to a state chartered bank, organized under the laws of the Commonwealth of Virginia, with membership in the Federal Reserve System. The Bank is now supervised and regularly examined by the Federal Reserve and the SCC and is subject to the laws and regulations administered by those regulatory authorities.

Limits on Dividends and Other Payments. The Corporation is a legal entity separate and distinct from the Bank. Most of the Corporation's revenues result from dividends paid to the Corporation by the Bank. The right of the Corporation, and consequently the right of creditors and shareholders of the Corporation, to participate in any distribution of the assets or earnings of the Bank through the payment of such dividends or otherwise is necessarily subject to the prior claims of creditors of the Bank, except to the extent that claims of the Corporation in its capacity as a creditor may be recognized.

The amount of dividends payable by the Bank to the Corporation depends upon the Bank's earnings and capital position, and is limited by federal and state law, regulations and policies.

As a state member bank subject to the regulations of the Federal Reserve Board, the Bank has to obtain the approval of the Federal Reserve Board for any dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits, as defined by the Federal Reserve Board, for that year, combined with its retained net profits for the preceding two years. In addition, the Bank may not pay a dividend in an amount greater than its undivided profits then on hand after deducting its losses and bad debts. For this purpose, bad debts are generally defined to include the principal amount of loans which are in arrears with respect to interest by six months or more unless such loans are fully secured and in the process of collection. Moreover, for purposes of this limitation, the Bank is not permitted to add the balance in its allowance for loan losses account to its undivided profits then on hand; however, it may net the sum of its bad debts as so defined in excess of that account. At December 31, 2002, the Bank had \$4.6 million of retained earnings legally available for the payment of dividends.

In addition, the Federal Reserve is authorized to determine under certain circumstances relating to the financial condition of a national bank, a

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state member bank or a bank holding company that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The payment of dividends that deplete a

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bank's capital base could be deemed to constitute such an unsafe or unsound practice. The Federal Reserve has indicated that banking organizations should generally pay dividends only out of current operating earnings.

Borrowings by the Corporation. There are various legal restrictions on the extent to which the Corporation can Borrow or otherwise obtain credit from the Bank. In general, these restrictions require that any such extensions of credit must be secured by designated amounts of specified collateral and are limited, as to the Corporation, to 10 percent of the Bank's capital stock and surplus, and as to the Corporation and any nonbanking subsidiaries in the aggregate, to 20 percent of the Bank's capital stock and surplus. Federal law also requires that transactions between the Bank and the Corporation or any nonbanking subsidiaries, including extensions of credit, sales of securities or assets and the provision of services, be conducted on terms at least as favorable to the bank as those that apply or would apply to comparable transactions with unaffiliated parties.

Capital Requirements

| | Year Ended December 31, 2002 |
|---------------------------------|------------------------------------|
| Required Capital Ratios: | |
| Leverage Ratio | 4.00% |
| Tier 1 risk-based capital ratio | 4.00 |
| Total risk-based capital ratio | 8.00 |
| The Corporation Capital Ratios: | |
| Leverage Ratio | 7.88% |
| Tier 1 risk-based capital ratio | 10.43% |
| Total risk-based capital ratio | 11.42% |

In January 1989, the Federal Reserve Board published risk-based capital guidelines in final form which are applicable to bank holding companies. The Federal Reserve Board guidelines redefine the components of capital, categorize assets into different risk classes and include certain off-balance sheet items in the calculation of risk-weighted assets. These guidelines became effective on March 15, 1989. The minimum ratio of qualified total capital to risk-weighted assets (including certain off balance sheet items, such as standby letters of credit) is 8.00%. At least half of the total capital must be comprised of common equity, retained earnings and a limited amount of permanent preferred stock, less goodwill ("Tier 1 capital"). The remainder ("Tier 2 capital") may consist of a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of loan and lease losses reserves. The Corporation's Tier 1 and Total Capital ratios as of December 31, 2002 were 10.43% and 11.42%, respectively.

In addition, the Federal Reserve Board has established minimum Leverage ratio (Tier 1 capital to quarterly average assets less goodwill) guidelines for bank holding companies. These guidelines provide for a minimum ratio of 3.00% for bank holding companies that meet certain specific criteria, including that they have the highest regulatory rating. All other bank holding companies will

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be required to maintain a Leverage ratio of 3.00% plus an additional cushion of at least 100 to 200 basis points. The Corporation's Leverage ratio as of December 31, 2002 was 7.88%. The guidelines also provide that a banking organization experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Under Federal Reserve Board policy, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the Federal Reserve Board's policy that, in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks. This support may be required during periods of financial stress or adversity or in circumstances

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where the financial flexibility and capital-raising capacity of the bank holding company would be called upon to obtain additional resources for assisting its subsidiary banks. The failure of a bank holding company to serve as a source of strength to its subsidiary banks would generally be considered by the Federal Reserve Board to be an unsafe and unsound banking practice, a violation of Federal Reserve regulations, or both.

FIRREA. In August 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"). Among other things, FIRREA abolished the Federal Savings and Loan Insurance Corporation and established two new insurance funds under the jurisdiction of the FDIC -- the Savings Association Insurance Fund ("SAIF") and the Bank Insurance Fund ("BIF"). The FDIC will set assessments for deposit insurance annually. The act requires that the FDIC reach an insurance fund reserve ratio for the BIF of \$1.25 for every \$100 of insured deposits within fifteen years. Assessments for the BIF and SAIF are set independently.

FIRREA also imposes, with certain exceptions, a "cross-guarantee" on the part of commonly controlled depository institutions. Under this provision, if one depository institution subsidiary of a multi-unit holding company fails or requires FDIC assistance, the FDIC may assess a commonly controlled depository institution for the estimated losses suffered by the FDIC. While the FDIC's claim is junior to the claims of non-affiliated depositors, holders of secured liabilities, general creditors, and subordinated creditors, it is superior to the claims of shareholders.

In addition, FIRREA grants numerous new or enhanced enforcement powers over financial institutions and individuals associated with them. Its criminal and civil liability provisions apply equally to banks and savings and loan associations and provide for stiffer civil fines and criminal penalties for any depository institution or any institution affiliated party who engages in or tolerates bank fraud or other wrongdoing.

FDICIA. The Federal Deposit Insurance Corporation Improvement Act ("FDICIA") was signed into law on December 19, 1991. Section 131 of FDICIA requires the federal banking agencies to develop a mechanism to take prompt and corrective action ("PCA") to resolve the problems of insured depository institutions ("IDI's"). Capital levels and supervisory concern determine a bank's PCA capital category.

Section 302 requires the FDIC to establish a risk-based assessment system. The system is designed as a matrix where each IDI will pay an assessment rate based on the combination of its capital and supervisory condition.

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Section 305 of FDICIA requires incorporating interest rate risk ("IRR") into the risk-based standard and a measurement system that would identify institutions with high levels of IRR and ensure that they have sufficient capital to cover their exposure. The measurement system will quantify IRR exposure through weighting and risk factors.

Depository institutions are required to establish non-capital standards for bank safety and soundness. These standards fall into three broad categories: operations and management standards for internal controls, loan documentation, and credit underwriting; asset quality, earnings and stock valuation standards; and executive compensation standards. The failure of a depository institution to meet these standards will trigger regulatory actions. Section 112 establishes guidelines for annual independent audit, annual report filings with regulatory agencies, independent audit reports and procedures, and independent audit committees.

Section 301 addresses brokered deposits with no restrictions on "well capitalized" institutions and restrictions based upon the capital threshold of remaining institutions. Truth in Savings ("TISA") or Regulation DD is intended to assist consumers in comparing deposit accounts principally through disclosures of fees, annual percentage yields, interest rates and other terms associated with interest-bearing deposit accounts. Compliance was mandatory on June 21, 1993. Section 304 requires a uniform standard for real estate lending establishing loan-to value ("LTV") ratio guidelines for real estate secured loans.

FDICIA contains a provision for IDI's to provide supplemental disclosure of the estimated fair value of assets and liabilities in reports required to be filed with federal banking agencies.

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FDICIA establishes various limitations on loans to bank insiders and prescribes standards that effectively limit the risks posed by an insured bank's exposure to other insured depository institutions ("Interbank Liabilities"). FDICIA also requires advance notice of a branch closure, the establishment of incentives to provide life-line accounts to low-income customers and addresses the frequency and scope of supervisory examinations. Clearly, the ultimate impact of FDICIA will be profound.

The Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Act of 1999 (the "GLB Act" or the "Act"), signed into law on November 12, 1999, amended a number of Federal banking laws that affect the Corporation and the Bank, and the provisions of the Act that are believed to be of most significance to the Corporation are discussed below. In particular, the GLB Act permits a bank holding company to elect to become a financial holding company. In order to become and maintain its status as a financial holding company, the bank holding company and all of its affiliated depository institutions must be well-capitalized, well-managed, and have at least a satisfactory Community Reinvestment Act rating. The Corporation filed an election and on April 3, 2001, became a financial holding company.

Under the BHCA, a bank holding company, including a financial holding company, may not directly or indirectly acquire ownership or control of more than 5% of the voting shares or substantially all of the assets of any bank or merge or consolidate with another bank holding company without the prior approval of the Federal Reserve Board. The BHCA, as amended by the GLB Act, now generally limits the activities of a bank holding company that is a financial holding company to that of banking, managing or controlling banks; performing certain servicing activities for subsidiaries; and engaging in any activity, or acquiring and retaining the shares of any company engaged in any activity, that

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is either (1) financial in nature or incidental to such financial activity, as determined by the Federal Reserve Board in consultation with the Secretary of the Treasury; or (2) complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally, as determined by the Federal Reserve Board, by order or regulation in effect prior to enactment of the GLB Act, to be closely related to banking or managing or controlling banks as to be a proper incident thereto.

The GLB Act covers a broad range of issues, including a repeal of most of the restrictions on affiliations among depository institutions, securities firms and insurance companies. In particular, the GLB Act repeals sections 20 and 32 of the Glass-Steagall Act, thus permitting unrestricted affiliations between banks and securities firms. The Act also provides that, while the states continue to have the authority to regulate insurance activities, in most instances they are prohibited from preventing or significantly interfering with the ability of a bank, directly or through an affiliate, to engage in insurance sales, solicitations or cross-marketing activities. A financial holding company, therefore, may engage in or acquire companies that engage in a broad range of financial services, including securities activities such as underwriting, dealing, brokerage, investment and merchant banking; and insurance underwriting, sales and brokerage activities. Although the states generally must regulate bank insurance activities in a nondiscriminatory manner, the states may continue to adopt and enforce rules that specifically regulate bank insurance activities in certain areas identified in the Act. The Act directs the Federal bank regulatory agencies to adopt insurance consumer protection regulations that apply to sales practices, solicitations, advertising and disclosures, and such regulations have been adopted and became effective April 1, 2001.

The GLB Act includes a system of functional regulation under which the Federal Reserve Board is confirmed as the umbrella regulator for bank holding companies, but bank holding company affiliates are to be principally regulated by functional regulators such as the FDIC for state nonmember bank affiliates, the Securities and Exchange Commission for securities affiliates and state insurance regulators for insurance affiliates. The Act repealed the broad exemption of banks from the definitions of "broker" and "dealer" for purposes of the Securities Exchange Act of 1934, but identifies a set of specific activities, including traditional bank trust and fiduciary activities, in which a bank may engage without being deemed a "broker" and a set of activities in which a bank may engage without being deemed a "dealer". The Act also makes conforming changes in the definitions of "broker" and "dealer" for purposes of the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

The GLB Act contains extensive customer privacy protection provisions. Under these provisions, a financial institution must provide to its customers, at the inception of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial

information. The Act provides that, except for certain limited exceptions, an institution may not provide such personal information to unaffiliated third parties unless the institution discloses to the customer that such information may be so provided and the customer is given the opportunity to opt out of such disclosure. An institution may not disclose to an unaffiliated party, other than to a consumer reporting agency, customer account numbers or other similar account identifiers for marketing purposes. The Act also provides that the states may adopt customer privacy protections that are more strict than those contained in the Act. The Act also makes it a criminal offense, except in limited circumstances, to obtain or attempt to obtain customer information of a financial nature by fraudulent or deceptive means. The Act also contains

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requirements for the posting of notices by operators of automated teller machines regarding fees charged for the use of such machines.

Government Policies and Legislation. The policies of regulatory authorities, including the Federal Reserve Board and the FDIC, have had a significant effect on the operating results of commercial banks in the past and are expected to do so in the future. An important function of the Federal Reserve is to regulate aggregate bank credit and money through such means as open market dealings in securities, establishment of the discount rate on member banks, borrowings, and changes in reserve requirements against member deposits. Policies at these agencies may be influenced by many factors, including inflation, unemployment, short-term and long-term changes in the international trade balance, and fiscal policies of the United States government.

Congress has periodically considered and adopted legislation which has resulted in, and could result in further, deregulation of both banks and financial institutions. Such legislation could modify or eliminate geographic restrictions on banks and bank holding companies and could modify or eliminate current prohibitions against the Corporation engaging in one or more non-banking activities. Such legislative changes also could place the Corporation in more direct competition with other financial institutions. No assurance can be given as to whether any additional legislation will be adopted and as to the effect of such legislation on the business of the Corporation.

Item 2. Description of Property

The principal executive offices of First National Corporation are located at 112 West King Street, Strasburg, Virginia, which is owned free of encumbrances. In addition to operating a full service banking facility at this Strasburg location, the Corporation operates seven additional branches and a loan production office. The Corporation owns five of these facilities without encumbrances and leases three of the facilities. The leases on these facilities including renewal options, expire in 2007. See Note 13 to the Consolidated Financial Statements of the Corporation's 2002 Annual Report to Shareholders for additional information concerning these lease commitments.

Item 3. Legal Proceedings

In the ordinary course of its operations, the Corporation is party to various legal proceedings. Based on information presently available, and after consultation with legal counsel, management believes that the ultimate outcome in such proceedings, in the aggregate, will not have a material adverse effect on the business or the financial condition or results of operations of the Corporation.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to security holders for a vote in the fourth quarter of 2002.

Part II

Item 5. Market for Common Equity and Related Stockholder Matters

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Shares of the common stock of the Corporation are traded on the over-the-counter (OTC) market and quoted in the OTC Bulletin Board under the symbol "FXNC." However, similar to the trading of the Bank's common stock prior to its reorganization, trading of the Corporation's common stock is generally the result of private negotiation. Increasingly, a broker or dealer may be involved.

The Corporation has a limited record of trades involving its common stock in the sense of "bid" and "asked" prices or in highs and lows. The effort to accurately disclose trading prices is made more difficult due to the fact that price per share information is not required to be disclosed to the Corporation when shares of its stock have been sold by holders and purchased by others. The following table summarizes the high and low sales prices of shares of the Corporation's common stock on the basis of trades known to the Corporation. The Corporation may not be aware of the per share price of all trades made.

Market Price and Dividends

| | Sales Price (\$) | | Dividend |
|------------------|------------------|-------|----------|
| | High | Low | |
| 2001: | | | |
| 1st quarter..... | 24.75 | 23.25 | . |
| 2nd quarter..... | 33.00 | 24.75 | . |
| 3rd quarter..... | 34.00 | 30.25 | . |
| 4th quarter..... | 33.75 | 31.50 | . |
| 2002: | | | |
| 1st quarter..... | 35.75 | 32.25 | . |
| 2nd quarter..... | 41.00 | 36.50 | . |
| 3rd quarter..... | 40.40 | 37.25 | . |
| 4th quarter..... | 40.25 | 37.25 | . |

 (1) The Corporation increased its dividend to \$1.38 per share in 2002, which represented a payout ratio of 36.60%. The dividend per share and payout ratios in 2001 were \$1.30 and 39.57%, respectively.

The Corporation had 695 shareholders of record as of February 28, 2003.

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

First National Corporation (the "Corporation") is the holding company for First Bank (the "Bank") and First Bank owns First Bank Financial Services Inc. ("Financial Services"). The following discussion and analysis of the financial condition and results of operations of the Corporation for the years ended December 31, 2002, 2001 and 2000 should be read in conjunction with the consolidated financial statements and related notes.

Overview

Earnings and assets continued to grow in 2002. Net income for 2002 was

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\$2,979,214 compared to \$2,595,334 in 2001 and \$2,136,787 in 2000. Net income per share increased \$0.48 per share, both basic and diluted in 2002 from 2001 (\$3.77 per share basic and diluted in 2002 versus \$3.29 per share basic and diluted in 2001). The increase in earnings resulted primarily from a continuing increase in the Bank's net interest income. Return on average assets was 1.09% in 2002, 1.10% in 2001 and .98% in 2000. Return on average equity was 12.99% in 2002, 12.57% in 2001 and 11.90% in 2000.

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Assets grew 18.7% in 2002. In 2001, assets grew 8.8%. Growth occurred primarily in the loan portfolio where loans, net of unearned income and allowance for loan losses, increased \$25.7 million to \$210.4 million. The securities portfolio also increased to \$54.5 million in 2002 from \$43.4 million in 2001.

Critical Accounting Policies

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The Corporation performs an analysis of the allowance for loan losses throughout the year, with the objective of quantifying portfolio risk into a dollar figure of inherent losses. In addition, internal loan reviews are performed on a regular basis. The determination of the allowance for loan losses is based on applying qualitative and quantitative factors to each category of loans along with any specific allowance for impaired and adversely classified loans within the particular category. The resulting sum is then combined to arrive at a total allowance for all categories. The Corporation assigns factors that include historical loss experience, delinquency rates and economic trends to each loan category for consideration of the qualitative factors. The total allowance required will fluctuate as a result of changes in the various types and categories of loans, specific allowances required due to impaired and adversely classified loans, the historical loss experience, delinquency rates and economic conditions.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosures.

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During the year ended December 31, 2002 there were no changes in critical accounting policies as reflected in the last report.

Results of Operations

Net interest income represents the primary source of earnings for the Corporation. Net interest income equals the amount by which interest income on earning assets, predominately loans and securities, exceeds interest expense on interest bearing liabilities, predominately deposits, short-term and long-term borrowings. The provision for loan losses and the amount of noninterest income and expense also have an effect on net income. Noninterest income and expense consists of income from service charges on deposit accounts; fees charged for various services; gains and losses from the sale of assets, both fixed assets and securities; and various administrative, operating and income tax expenses.

Changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as their respective yields and rates, have a significant impact on the level of net interest income. Net interest margin is calculated by dividing tax equivalent net interest income by average earning assets and reflects the Company's net yield on its earning assets.

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General. Net income has increased in each of the last three years. The increase in income in 2002 was caused by growth in earning assets and by the funding of higher yielding assets, in part, from lower priced deposits. In 2001 and 2000 net interest income increased as the Corporation continued to experience favorable asset growth.

Net Interest Income. Net interest income was \$9.41 million for the year ended December 31, 2002, up \$754 thousand or 8.72% over the \$8.65 million reported for the same period in 2001. This increase in net interest income resulted from an increase in interest-earning assets and a decrease in the rates paid on deposit accounts during the year. In 2001, net interest income increased 13.55% or \$1.03 million from \$7.62 million in 2000.

Interest income as a percent of average earning assets has decreased in each of the last three years from 8.29% in 2000, 7.78% in 2001 and 6.74% in 2002. Interest expense as a percent of average interest-bearing liabilities has also decreased from 5.26% in 2000, 4.58% in 2001 and 3.55% in 2002. Net interest margin was 3.75% in 2002, 3.93% in 2001, and 3.77% in 1999. Interest rate spread was 3.19% in 2002, 3.20% in 2001 and 3.03% in 2000. The yield on earning assets continued to decline during 2002 as earning assets repriced at lower interest rates.

Provision for Loan Losses. The provision for 2002 was \$405,000 compared to \$420,000 in 2001 and \$369,000 in 2000. The amount allocated during the year to the provision for loan losses represents management's analysis of the existing loan portfolio and related credit risks.

Non-Interest Income. Non-interest income increased \$977 thousand or 62.3% for 2002 over 2001 compared to an increase of \$166 thousand or 11.8% for 2001 over 2000. The increase in non-interest income is primarily attributed to service charges, which increased \$391 thousand in 2002 and to an increase of \$178 thousand in fees for other customer services. Gains on securities available for sale totaled \$172 thousand during 2002 and losses totaled \$4 thousand during 2001. There were no sales of securities available for sale in 2000. Increased mortgage loan activity contributed to gains on sale of loans totaling \$198 thousand in 2002, \$71 thousand in 2001 and \$7 thousand in 2000.

Non-Interest Expense. In 2002, non-interest expenses increased \$1.2

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million or 19.0% over 2001. In 2001, non-interest expenses increased \$453 thousand or 8.1% over 2000. The increase in 2002 was primarily the result of the increase in salaries and benefits and other operating expenses.

Income Taxes. The Corporation has adopted FASB Statement No. 109, "Accounting for Income Taxes". A more detailed discussion of the Corporation's tax calculation is contained in the notes to the consolidated financial statements.

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Table 1 - Selected Consolidated Financial Data

| | Years Ended December 31, | | | |
|-----------------------------------------------------|--------------------------------------------|-----------|-----------|-----------|
| | (in thousands except ratios and per share) | | | |
| | 2002 | 2001 | 2000 | 1999 |
| Income Statement Data: | | | | |
| Interest Income | \$17,058 | \$17,326 | \$16,951 | \$15,211 |
| Interest Expense | 7,653 | 8,675 | 9,332 | 7,688 |
| Net Interest Income | 9,405 | 8,651 | 7,619 | 7,533 |
| Provision For Loan Losses | 405 | 420 | 369 | 499 |
| Net Interest Income After Provision For Loan Losses | 9,000 | 8,231 | 7,250 | 7,034 |
| Noninterest Income | 2,373 | 1,572 | 1,402 | 1,111 |
| Securities Gains (Losses) | 172 | (4) | 0 | 0 |
| Noninterest Expense | 7,219 | 6,064 | 5,611 | 5,277 |
| Income Before Income Taxes | 4,326 | 3,735 | 3,041 | 2,888 |
| Income Taxes | 1,347 | 1,140 | 904 | 855 |
| Net Income | \$2,979 | \$2,595 | \$2,137 | \$2,033 |
| Per Share Data: | | | | |
| Net Income, Basic | \$3.77 | \$3.29 | \$2.69 | \$2.55 |
| Net Income, Diluted | 3.77 | 3.29 | 2.69 | 2.55 |
| Cash Dividends | 1.38 | 1.30 | 1.20 | 1.11 |
| Book Value At Period End | 30.70 | 27.34 | 24.47 | 21.61 |
| Balance Sheet Data: | | | | |
| Assets | \$295,936 | \$249,354 | \$229,329 | \$206,611 |
| Loans, Net | 210,441 | 184,765 | 164,603 | 149,311 |
| Securities | 54,485 | 43,355 | 44,831 | 45,121 |
| Deposits | 243,012 | 197,479 | 175,194 | 153,421 |
| Stockholders' Equity | 24,254 | 21,600 | 19,329 | 17,171 |
| Average Shares Outstanding, Diluted | 790 | 790 | 794 | 799 |
| Performance Ratios: | | | | |
| Return On Average Assets | 1.09% | 1.10% | 0.98% | 1.00% |
| Return On Average Equity | 12.99% | 12.57% | 11.90% | 11.63% |
| Dividend Payout | 36.60% | 39.57% | 44.56% | 44.72% |
| Capital And Liquidity Ratios: | | | | |
| Leverage | 7.88% | 8.97% | 8.67% | 8.91% |
| Risk-Based Capital Ratios: | | | | |
| Tier 1 Capital | 10.43% | 10.34% | 11.28% | 12.74% |

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Total Capital 11.42% 11.31% 12.26% 13.73%

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Table 2 - Average Balances, Income and Expense Ratios
Years Ended December 31

| ASSETS | Average Balance | 2002 Annual Income/Expense | Yield/Rate | Average Balance | 2001 Annual Income/Expense | Yield/Rate |
|----------------------------------------------|-----------------|----------------------------|------------|-----------------|----------------------------|------------|
| Balances at correspondent banks | | | | | | |
| - interest bearing | \$1,214,110 | \$44,902 | 3.70% | \$1,397,710 | \$73,164 | 5.2% |
| Securities: | | | | | | |
| Taxable | 45,142,996 | 2,216,450 | 4.91% | 34,600,602 | 2,005,522 | 5.8% |
| Tax-exempt (1) | 6,236,303 | 459,364 | 7.29% | 6,801,538 | 497,774 | 7.3% |
| Total Securities | 51,379,299 | 2,675,814 | 5.21% | 41,402,140 | 2,503,296 | 6.0% |
| Loans (net of earned income): (2) | | | | | | |
| Taxable | 197,542,256 | 14,342,918 | 7.26% | 177,125,433 | 14,681,390 | 8.2% |
| Tax-exempt (1) | 1,375,620 | 110,155 | 8.01% | 1,037,843 | 88,342 | 8.5% |
| Total Loans | 198,917,876 | 14,453,073 | 7.27% | 178,163,276 | 14,769,732 | 8.2% |
| Federal funds sold and repurchase agreements | 4,609,904 | 76,890 | 1.67% | 4,230,045 | 178,754 | 4.2% |
| Total earning assets | 256,121,189 | 17,250,679 | 6.74% | 225,193,171 | 17,524,946 | 7.7% |
| Less: allowance for Loan Losses | (2,072,676) | | | (1,817,252) | | |
| Total nonearning assets | 18,099,672 | | | 12,568,264 | | |
| Total Assets | \$272,148,185 | | | \$235,944,183 | | |
| LIABILITIES AND SHAREHOLDER EQUITY | | | | | | |
| Interest bearing deposits: | | | | | | |
| Checking | \$35,598,074 | \$678,507 | 1.91% | \$12,614,190 | \$156,986 | 1.2% |
| Money market savings | 7,735,680 | 113,731 | 1.47% | 6,588,356 | 159,561 | 2.4% |
| Regular savings | 52,670,319 | 889,609 | 1.69% | 61,210,167 | 2,041,066 | 3.3% |
| Certificates of deposit: | | | | | | |
| Less than \$100,000 | 63,170,927 | 3,016,202 | 4.77% | 56,582,840 | 3,205,785 | 5.6% |
| \$100,000 and more | 29,117,733 | 1,275,892 | 4.38% | 22,437,125 | 1,243,602 | 5.5% |
| Total interest bearing deposits | 188,292,733 | 5,973,941 | 3.17% | 159,432,678 | 6,807,000 | 4.2% |
| Fed funds purchased | 302,573 | 6,455 | 2.13% | 90,708 | 3,981 | 4.3% |
| FHLB borrowings | 26,988,457 | 1,672,341 | 6.20% | 29,839,142 | 1,863,552 | 6.2% |
| Total interest bearing liabilities | 215,583,763 | 7,652,737 | 3.55% | 189,362,528 | 8,674,533 | 4.5% |
| Noninterest bearing liabilities | | | | | | |
| Demand deposits | 31,397,327 | | | 23,980,571 | | |
| Other liabilities | 2,228,001 | | | 1,954,027 | | |
| Total liabilities | 249,209,091 | | | 215,297,126 | | |
| Stockholders' equity | 22,939,094 | | | 20,647,057 | | |
| Total liabilities and | | | | | | |

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| | | | | |
|---------------------------------------------------------|---------------|-------------|---------------|-------------|
| stockholders' equity | \$272,148,185 | | \$235,944,183 | |
| | ===== | | ===== | |
| Net Interest income | | \$9,597,942 | | \$8,850,413 |
| | | ===== | | ===== |
| Interest rate spread | | | 3.19% | 3.2 |
| Interest expense as a percent of average earning assets | | | 2.99% | 3.8 |
| Net interest margin | | | 3.75% | 3.9 |

-
- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%.
- (2) Loans placed on a nonaccrual status are reflected in the balances.

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Table 3 - Volume and Rate Analysis

| | | 2002 | Change in | | 2001 | |
|----------------------------------------------|--------------------|-----------------------|-----------------------|--------------------|-----------------------|-------------|
| | Volume Effect | Rate Effect | Income/Expense | Volume Effect | Rate Effect | Ch |
| Earning Assets: | | | | | | |
| Due From Banks | \$ (8,758) | \$ (19,504) | \$ (28,262) | \$20,400 | \$ (6,427) | |
| Taxable Securities | 424,936 | (214,008) | 210,928 | (171,716) | (188,013) | (|
| Tax-Exempt Securities | (36,605) | (1,805) | (38,410) | (1,241) | 2,045 | |
| Taxable Loans | 4,345,373 | (4,683,845) | (338,472) | 1,383,685 | (658,931) | |
| Tax-Exempt Loans | 26,618 | (4,805) | 21,813 | 32,540 | (10,508) | |
| Federal Funds Sold and Repurchase Agreements | 17,748 | (119,612) | (101,864) | 7,336 | (4,575) | |
| | ----- | ----- | ----- | ----- | ----- | |
| Total Earning Assets | \$4,769,312 | \$ (5,043,579) | \$ (274,267) | \$1,271,004 | \$ (866,409) | \$ |
| | ----- | ----- | ----- | ----- | ----- | |
| Interest Bearing Liabilities: | | | | | | |
| Interest Checking | \$402,239 | \$119,282 | \$521,521 | \$6,754 | \$ (8,210) | |
| Savings Deposits- | | | | | | |
| Regular | (254,186) | (897,271) | (1,151,457) | 135,136 | (1,201,330) | (1, |
| Money Market | 36,540 | (82,370) | (45,830) | 22,507 | (51,099) | |
| CD's and Other Time Deposits | | | | | | |
| \$100,000 and More | 108,806 | (76,516) | (189,583) | 357,174 | (61,077) | |
| Less Than \$100,000 | 521,866 | (711,449) | 32,290 | 400,669 | 75,459 | |
| | ----- | ----- | ----- | ----- | ----- | |
| Total Interest-Bearing Deposits | \$815,265 | \$ (1,648,324) | \$ (833,059) | \$922,240 | \$ (1,246,257) | \$ (|
| Fed Funds Purchased | 3,173 | (699) | 2,474 | (43,344) | (15,323) | |
| FHLB Borrowings | (176,436) | (14,775) | (191,211) | (295,979) | 20,985 | (|
| | ----- | ----- | ----- | ----- | ----- | |
| Total Interest-Bearing Liabilities | \$642,002 | \$ (1,663,798) | \$ (1,021,796) | \$ 582,917 | \$ (1,240,595) | \$ (|
| | ----- | ----- | ----- | ----- | ----- | |
| Change in Net Interest Income | \$4,127,310 | \$ (3,379,781) | \$747,529 | \$688,087 | \$ 374,186 | \$1, |

Financial Condition

General. Management continued to increase the size of the loan portfolio in 2002. Loans, net of unearned discounts and allowance for loan losses, increased \$25.7 million or 13.9% from \$184.7 million in 2001 to \$210.4 million in 2002. This growth in loans was reflected in an 18.7% increase in assets during the year. Assets began the year at \$249.4 million and grew \$46.5 million to \$295.9 million by year-end.

Loans. The Bank is an active lender with a loan portfolio which includes commercial and residential mortgages, commercial loans, consumer loans, both installment and credit card loans, real estate construction loans and home equity loans. The Bank's lending activity is concentrated on individuals and small to medium sized businesses in its primary trade area of the Virginia counties of Shenandoah, Warren, Clarke, Frederick and the City of Winchester. As a provider of community oriented financial services, the Bank does not attempt to geographically diversify its loan portfolio by undertaking significant lending activity outside its primary trade area.

The Bank's loan portfolio is summarized in table 4 for the periods indicated.

Table 4 - Loan Portfolio

Loans at December 31, by year are summarized as follows:

| | 2002 | 2001 | 2000 | 1999 |
|------------------------------------------------------------|------------------------|-----------|-----------|-----------|
| | (dollars in thousands) | | | |
| Commercial, Financial, and Agricultural | \$29,458 | \$42,101 | \$36,500 | \$26,907 |
| Real Estate Construction | 12,172 | 9,648 | 8,836 | 10,205 |
| Real Estate-Mortgage: | | | | |
| Residential (1-4 Family) | 58,705 | 35,999 | 37,046 | 58,712 |
| Non-Farm, Non-Residential | 67,680 | 57,761 | 46,124 | 20,971 |
| Secured by Farmland | 2,112 | 2,094 | 1,791 | 1,489 |
| Consumer | 36,828 | 35,248 | 34,024 | 31,829 |
| All Other Loans | 5,648 | 3,893 | 1,990 | 670 |
| Total Loans | \$212,603 | \$186,744 | \$166,311 | \$150,783 |
| Less Unearned Income | --- | 3 | 5 | 23 |
| Less Allowance for Loan Losses | 2,162 | 1,976 | 1,703 | 1,447 |
| Loans-Net of Unearned Income and Allowance for Loan Losses | \$210,441 | \$184,765 | \$164,603 | \$149,313 |

As shown in Table 4 above, the total amount of commercial, financial and agricultural loans decreased \$12.6 million in 2002. Residential real estate mortgage loans increased \$22.7 million in 2002 after decreasing \$0.7 million in 2001. Non-farm, non residential mortgage loans increased in 2002 by \$9.9 million and increased in 2001 by \$11.6 million. The growth in the consumer loan area

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continued in 2002 with an increase of \$1.6 million compared to an increase of \$1.2 million in 2001.

There was no category of loans that exceeded 10% of outstanding loans at December 31, 2002 which were not disclosed in Table 4.

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Table 5 - Remaining Maturities of Selected Loans

| | At December 31, 2002 | |
|------------------|-------------------------------------------------------|--------------------------------------|
| | Commercial Financial, and Agricultural ----- | Real Estate Construction ----- |
| | (dollars in thousands) | |
| Within 1 Year: | \$15,966 ----- | \$7,972 ----- |
| Variable Rate: | | |
| 1 to 5 Years | \$2,585 | \$3,198 |
| After 5 Years | 1,650 | - - |
| Total | \$ 4,235 ----- | \$3,198 ----- |
| Fixed Rate: | | |
| 1 to 5 Years | \$ 8,932 | \$1,002 |
| After 5 Years | 325 | - - |
| Total | \$ 9,257 ----- | \$ 1,002 ----- |
| Total Maturities | \$ 29,458 ===== | \$ 12,172 ===== |

Asset Quality. The Allowance for Loan Losses ("ALL") balance was \$2,161,622 and \$1,975,916 at December 31, 2002 and 2001, representing 1.02% and 1.06% of total loans, respectively. Non-performing assets totaled \$191,854 and \$118,113 at December 31, 2002 and 2001, representing 8.88% and 5.98% of the Allowance for Loan Losses, respectively.

Total losses charged against the ALL in 2002 were \$249,987 compared to \$181,623 in 2001, and \$165,135 in 2000. Recoveries, consisting of the recovery of principal on loans previously charged against the allowance, totaled \$30,693 in 2002, \$34,683 in 2001, and \$51,980 in 2000.

Management believes, based upon its review and analysis, that the Bank has sufficient reserves to cover any projected losses within the total loan portfolio.

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Allowance for Loan Losses. Changes in the allowance for loan losses are

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detailed in Table 6.

Table 6 - Allowance For Loan Losses

| | 2002 ---- | At December 31 | |
|----------------------------------------------------------------------------------------------|--------------|-----------------------|--------------|
| | | 2001 ---- | 2000 ---- |
| | | (dollars in thousand) | |
| Balance, Beginning of Period | \$1,976 | \$1,703 | \$1,447 |
| Loans Charged-Off | | | |
| Commercial, Financial and Agricultural | -- | -- | 10 |
| Real Estate-Construction | -- | -- | -- |
| Real Estate-Mortgage | -- | -- | -- |
| Residential (1-4 Family) | -- | 37 | -- |
| Non-Farm, Non Residential | -- | -- | -- |
| Secured by Farmland | -- | -- | -- |
| Consumer | 250 | 145 | 146 |
| All Other Loans | -- | -- | 9 |
| Total Loans Charged Off | 250 | 182 | 165 |
| Recoveries | | | |
| Commercial, Financial and Agricultural | -- | -- | 4 |
| Real Estate-Construction | -- | -- | -- |
| Real Estate-Mortgage | -- | -- | -- |
| Residential (1-4 Family) | -- | -- | -- |
| Non-Farm, Non-Residential | -- | -- | -- |
| Secured by Farmland | -- | -- | -- |
| Consumer | -- | 35 | 48 |
| All Other Loans | 31 | -- | -- |
| Total Recoveries | 31 | 35 | 52 |
| Net Charge-Offs | 219 | 147 | 113 |
| Provision For Loan Losses | 405 | 420 | 369 |
| Balance, End of Period | \$2,162 | \$1,976 | \$1,703 |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.11% | 0.08% | 0.07% |

For each period presented, the provision for loan losses charged to operating expense was based on management's judgement after taking into consideration all factors connected with the collectability of the existing portfolio. Management considers economic conditions, changes in the nature and value of the portfolio, industry standards and other relevant factors when evaluating the loan portfolio. Specific factors considered by management when determining the amount to be provided included internally generated loan quality reports which analyze each problem loan to estimate amounts of probable loss and previous loss experience with various loan categories.

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Table 7 shows the balance and percentage of the Bank's allowance for loan losses allocated to each major category of loans.

Table 7 - Allocation of Allowance For Loan Losses

| | 2002 | | 2001 | | 2000 | | 199 |
|----------------------------------------------|------------------------|--------------------------------------------------------------|-----------|--------------------------------------------------------------|-----------|--------------------------------------------------------------|-----------|
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| | Allowance | Percent of Loans in Each Category to Total Loans | Allowance | Percent of Loans in Each Category to Total Loans | Allowance | Percent of Loans in Each Category to Total Loans | Allowance |
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| | (dollars in thousands) | | | | | | |
| Commercial, Financial And Agricultural | \$1,286 | 13.56% | \$518 | 22.44% | \$447 | 21.88% | \$251 |
| Real Estate- Construction | 155 | 5.73% | 0 | 5.14% | 0 | 5.30% | 0 |
| Real Estate- Mortgage | 267 | 60.84% | 918 | 51.56% | 791 | 51.24% | 738 |
| Consumer | 434 | 17.32% | 521 | 18.79% | 449 | 20.39% | 447 |
| All Other | 20 | 2.55% | 19 | 2.07% | 16 | 1.19% | 11 |
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| | \$2,162 | 100.00% | \$1,976 | 100.00% | \$1,703 | 100.00% | \$1,447 |
| | ===== | ===== | ===== | ===== | ===== | ===== | ===== |

Non-Performing Assets. Management classifies as non-performing both those loans on which payment has been delinquent 90 days or more and for which there is a risk of loss to either principal or interest, and Other Real Estate Owned. Other Real Estate Owned represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. Other Real Estate Owned is booked at the lower of cost or market less estimated selling costs, and is actively marketed by the Bank through brokerage channels.

Impairment of loans having recorded investments of \$26,294 at December 31, 2002 and \$80,783 at December 31, 2001 has been recognized in conformity with FASB Statement No. 114. The average recorded investment in impaired loans during 2002 and 2001 was \$47,520 and \$58,722, respectively, while the total allowance for loan losses related to these loans was \$13,147 and \$40,392, respectively. Interest income on impaired loans recognized for cash payments received in 2001 were \$3,136. There were no cash payments received on impaired loans in 2002 that were recognized as interest income.

Nonaccrual loans excluded from impaired loan disclosure under FASB 114 amounted to \$165,560 and \$37,330 at December 31, 2002 and 2001, respectively. If interest on these loans had been accrued, such income would have approximated \$4,511 and \$500 for 2002 and 2001, respectively.

When a loan is placed on non-accrual status there are several negative implications as a result. First, all interest accrued but unpaid at the time of

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the classification is deducted from the interest income totals for the Bank. Second, accruals of interest are discontinued until it becomes certain that both principal and interest can be repaid. Third, there may be actual losses which necessitate additional provisions for credit losses charged against earnings.

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Table 8 - Non-Performing Assets

| | 2002 ---- | 2001 ---- | At December 31 2000 ---- |
|-----------------------------------------------------------------------|--------------|--------------|--------------------------------|
| | | | (dollars in thousands) |
| Nonaccrual Loans | \$192 | \$118 | \$208 |
| Restructured Loans | -- | -- | -- |
| Foreclosed Property | -- | -- | -- |
| Total Nonperforming Assets | \$192 | \$118 | \$208 |
| Loans Past Due 90 Days Accruing Interest | \$1,397 | \$988 | \$282 |
| Allowance for Loan Losses to Period End Loans | 1.02% | 1.06% | 1.02% |
| Nonperforming Assets to Period End Loans and Foreclosed Properties | 0.09% | 0.06% | 0.13% |
| Net Charge-Offs (Recoveries) to Average Loans | 0.11% | 0.08% | 0.07% |

The Bank has reserved \$443,491 in the allowance for loan losses for potential problem loans. These loans present potential risk of non-payment and are not included in nonperforming assets above.

Securities. Securities at December 31, 2002 were \$54.5 million, an increase of \$11.1 million or 25.7% from the \$43.4 million at the end of 2001.

As of December 31, 2002, neither the Corporation nor the Bank held any derivative financial instruments in their respective investment security portfolios.

Table 9 summarizes the carrying value of the Corporation's securities portfolio on the dates indicated.

Table 9 - Securities Portfolio

| | 2002 ---- | 2001 ---- |
|-------------------------------|--------------|--------------|
| Book Value: | | |
| Securities Available for Sale | | |

(dollars in thousands)

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| | | |
|-----------------------------------|----------|----------|
| U.S. Government Securities | \$45,903 | \$33,929 |
| States and Political Subdivisions | 6,236 | 6,726 |
| Other Securities | 2,346 | 2,700 |
| | ----- | ----- |
| Total Securities | \$54,485 | \$43,355 |
| | ===== | ===== |

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Investment Portfolio Maturity Distribution/Yield Analysis
At December 31, 2002

| | One Year or Less | One to Five Years | Five to Ten Years | Over Ten Years And Equity Securities | To |
|----------------------------------|---------------------|----------------------|----------------------|--------------------------------------------|----|
| (dollars in thousands) | | | | | |
| Available for Sale Securities | | | | | |
| U.S. Government Securities | | | | | |
| Amortized Cost | 1,225 | 10,811 | 7,742 | 24,641 | 44 |
| Market Value | 1,254 | 11,430 | 7,887 | 25,332 | 45 |
| Weighted Ave. Yield | 5.04% | 5.20% | 4.57% | 5.33% | |
| State and Political Subdivisions | | | | | |
| Amortized Cost | 0 | 0 | 3,406 | 2,596 | 6 |
| Market Value | 0 | 0 | 3,560 | 2,676 | 6 |
| Weighted Ave. Yield (1) | 0.00% | 0.00% | 6.79% | 6.80% | |
| Other Securities | | | | | |
| Amortized Cost | 0 | 0 | 0 | 2,375 | 2 |
| Market Value | 0 | 0 | 0 | 2,346 | 2 |
| Weighted Ave. Yield | 0.00% | 0.00% | 0.00% | 5.24% | |
| Total Portfolio | | | | | |
| Amortized Cost | 1,225 | 10,811 | 11,148 | 29,512 | 52 |
| Market Value | 1,254 | 11,430 | 11,447 | 30,354 | 54 |
| Weighted Ave. Yield (1) | 5.04% | 5.20% | 5.25% | 5.45% | |

(1) Yields on tax exempt securities have been computed on a tax-equivalent basis.

This schedule has been prepared using the contractual maturities for all securities with the exception of mortgaged-backed securities (MBS's) and collateralized mortgage obligations (CMO's). Both MBS and CMO securities were recorded using dealer median prepayment speed assumptions, which is an industry standard.

Deposits. The Bank has made an effort in recent years to increase core deposits and control costs of funds. Deposits provide funding for the Corporation's investments in loans and securities, and the interest paid for deposits must be managed carefully to control the level of interest expense.

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Deposits at December 31, 2002 were \$243.0 million, an increase of \$45.5 million or 23.1% from \$197.5 million at December 31, 2001. Savings and interest bearing demand deposits increased \$26.7 million or 33.2% while non-interest-bearing demand deposits increased \$9.7 million or 35.9% and time deposits increased \$9.1 million or 10.2%.

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The following tables are a summary of average deposits and average rates paid.

Table 10 - Average Deposits and Rates Paid

| | 2002 | | Year Ended December 31, 2001 | | |
|---------------------------------------------|-----------|-------|---------------------------------|-------|------|
| | Amount | Rate | Amount | Rate | |
| Noninterest Bearing Deposits | \$31,397 | -- | \$23,981 | -- | \$2 |
| <hr style="border-top: 1px dashed black;"/> | | | | | |
| Interest Bearing Deposits | | | | | |
| Interest Checking | 35,598 | 1.91% | \$12,614 | 1.24% | \$1 |
| Money-Market | 7,736 | 1.47% | 6,588 | 2.42% | |
| Regular Savings | 52,670 | 1.69% | 61,210 | 3.33% | 5 |
| Time Deposits | | | | | |
| Less than \$100,000 | 63,171 | 4.77% | 56,584 | 5.67% | 4 |
| \$100,000 and more | 29,118 | 4.38% | 22,437 | 5.54% | 1 |
| <hr style="border-top: 1px dashed black;"/> | | | | | |
| Total Interest Bearing | \$188,293 | 3.17% | \$159,433 | 4.27% | \$14 |
| <hr style="border-top: 1px dashed black;"/> | | | | | |
| Total | \$219,690 | | \$183,414 | | \$16 |
| <hr style="border-top: 3px double black;"/> | | | | | |

Maturities of CD's of \$100,000 and More

| | Within Three Months | Three to Six Months | Six to Twelve Months | Over One Year | Total |
|------------------------|---------------------------|---------------------------|----------------------------|---------------------|----------|
| (dollars in thousands) | | | | | |
| At December 31, 2002 | \$8,454 | \$2,387 | \$5,655 | \$15,925 | \$32,421 |

Liquidity. Liquidity represents an institution's ability to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with banks, federal funds sold, investments in securities, and loans maturing within one

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year. As a result of the Bank's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' credit needs.

At December 31, 2002, cash, interest bearing and non-interest bearing deposits with banks, federal funds sold, securities, and loans maturing within one year were \$66.7 million. As of December 31, 2002, approximately 22.3% or \$47.7 million of the loan portfolio would mature or reprice within a one year period.

As of December 31, 2002, non-deposit sources of funds totaled \$26.6 million, primarily comprised of Federal Home Loan Bank (FHLB) borrowings. Activity during the year included monthly principal reductions associated with the Principal Reducing Credit (PRC) advances. During 2001, the bank booked a new borrowing in the amount of \$300,000 in relation to a real estate transaction, whereby the new branch site was purchased for the

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Front Royal Financial Services Center. Certainly, the bank would not typically utilize such financing; however, it was necessary to consummate the transaction.

Table 11 - Interest Sensitivity Analysis

| | Within 90 days | 90-365 Days | 1 to 5 years |
|------------------------------------|-------------------|----------------|-----------------|
| (dollars in thousands) | | | |
| <hr/> | | | |
| Earning Assets | | | |
| Loans (1) | \$ 18,231 | \$ 29,839 | \$ 140,413 |
| Investment securities | - | 1,254 | 11,430 |
| Deposits with other institution | 1,138 | - | - |
| Federal funds sold | 2,791 | - | - |
| | <hr/> | | |
| Total earning assets | \$ 22,160 | \$ 31,093 | \$ 151,843 |
| <hr/> | | | |
| Interest-Bearing Liabilities | | | |
| Interest bearing checking (2) | \$ - | \$ - | \$ 53,663 |
| Savings (2) | - | - | 45,391 |
| Money market deposit | 8,065 | - | - |
| Time deposits | 77 | 46,266 | 52,969 |
| Long-term debt | - | 50 | 16,370 |
| | <hr/> | | |
| Total interest-bearing liabilities | \$ 8,142 | \$ 46,316 | \$ 168,393 |
| <hr/> | | | |
| Period gap | 14,018 | (15,223) | (16,550) |
| Cumulative gap | 14,018 | (1,205) | (17,755) |

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| | | | |
|----------------------------------------------------|-------|---------|-------|
| Ratio of cumulative gap to Total earning assets | 5.15% | (0.44%) | 6.52% |
|----------------------------------------------------|-------|---------|-------|

(1) Includes nonaccrual loans and loans held for sale.

(2) The Bank has determined that interest checking and savings accounts are not sensitive to changes in related market rates and, therefore, the Bank has placed them in the 1 to 5 years category.

Capital Resources. The adequacy of the Corporation's capital is reviewed by management on an ongoing basis with reference to the size, composition, and quality of the Corporation'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 Board of Governors of the Federal Reserve System has adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.0%, of which at least 4.0% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. The Corporation had a ratio of risk-weighted assets to total capital of 11.42% at December 31, 2002 and a ratio of

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risk-weighted assets to Tier 1 capital of 10.43%. Both of these exceed the capital requirements adopted by the federal regulatory agencies.

Table 12- Analysis of Capital

| | At December 2002 | 2001 |
|---------------------------------|---------------------|-----------|
| | (Dollars in Thou) | |
| Tier 1 Capital | | |
| Common Stock | \$3,950 | \$3,950 |
| Surplus | 1,465 | 1,465 |
| Retained Earnings | 17,659 | 15,770 |
| | ----- | ----- |
| Total Tier 1 Capital | \$23,074 | \$21,185 |
| Tier 2 Capital: | | |
| Allowance for Loan Losses (1) | 2,162 | 1,970 |
| | ----- | ----- |
| Total Risk Based Capital | \$25,236 | \$23,155 |
| | ===== | ===== |
| Risk-Weighted Assets | \$221,050 | \$204,840 |
| Capital Ratios: | | |
| Tier 1 Risk-Based Capital Ratio | 10.43% | 10.34% |
| Total Risk-Based Capital Ratio | 11.42% | 11.31% |

(1) Limited to 1.25% of risk weighted assets.

Trust Preferred Capital Notes

On March 11, 2003, First National (VA) Statutory Trust I ("the Trust"), a wholly-owned subsidiary of the Corporation, was formed for the purpose of issuing redeemable capital securities. On March 26, 2003, \$3 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 March 31, 2002 was 4.41%. The securities have a mandatory redemption date of March 26, 2033, and are subject to varying call provisions beginning March 26, 2008. The principal asset of the Trust is \$3 million of the Corporation's junior subordinated debt securities with maturities and interest rates like the capital securities.

The trust preferred securities may be included in Tier I capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier I capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier I capital, if any, may be included in Tier 2 capital. The total amount (\$3 million) of trust preferred securities issued by the Trust can be included in the Corporation's Tier I capital.

Recent Accounting Pronouncements

In December 2001, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 01-6, "Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others," to reconcile and conform the accounting and financial reporting provisions established by various AICPA industry audit guides. This Statement is effective for annual and interim financial statements issued for fiscal years beginning after December 15, 2001, and did not have a material impact on the Corporation's consolidated financial statements.

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On March 13, 2002, the Financial Accounting Standard Board determined that commitments for the origination of mortgage loans that will be held for sale must be accounted for as derivatives instruments, effective for fiscal quarters beginning after April 10, 2002. The Bank enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding. Such rate lock commitments on mortgage loans to be sold in the secondary market are considered derivatives. Accordingly, these commitments, including any fees received from the potential borrower, are recorded at fair value in derivative assets or liabilities, with changes in fair value recorded in the net gain or loss on sale of mortgage loans. Fair value is based on fees currently charged to enter into similar agreements and, for fixed-rate commitments, also considers the difference between current levels of interest rates and the committed rates. The cumulative effect of adopting Statement No. 133 for rate lock commitments as of December 31, 2002, was not material. The Corporation originally adopted Statement No. 133, Accounting for Derivative Instruments and Hedging Activities on January 1, 2001.

In April 2002, the Financial Accounting Standards Board issued Statement 145, Rescission of FASB No. 4, 44, and 64, Amendment of FASB Statement

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No. 13, and Technical Corrections. The amendment to Statement 13 eliminates an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The provisions of this Statement related to the rescission of Statement 4 shall be applied in fiscal years beginning after May 15, 2002. The provisions of this Statement related to Statement 13 are effective for transactions occurring after May 15, 2002, with early application encouraged.

In June 2002, the Financial Accounting Standards Board issued Statement 146, Accounting for Costs Associated with Exit or Disposal Activities. This Statement requires recognition of a liability, when incurred, for costs associated with an exit or disposal activity. The liability should be measured at fair value. The provisions of the Statement are effective for exit or disposal activities initiated after December 31, 2002.

Effective January 1, 2002, the Corporation adopted Financial Accounting Standards Board Statement No. 142, Goodwill and Other Intangible Assets. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, Statement 142 requires that acquired intangible assets (such as core deposit intangibles) be separately recognized if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over their estimated useful life. Branch acquisition transactions were outside the scope of the Statement and therefore any intangible asset arising from such transactions remained subject to amortization over their estimated useful life.

In October 2002, the Financial Accounting Standards Board issued Statement No. 147, Acquisitions of Certain Financial Institutions. The Statement amends previous interpretive guidance on the application of the purchase method of accounting to acquisitions of financial institutions, and requires the application of Statement No. 141, Business Combinations, and Statement No. 142 to branch acquisitions if such transactions meet the definition of a business combination. The provisions of the Statement do not apply to transactions between two or more mutual enterprises. In addition, the Statement amends Statement No. 144, Accounting for the Impairment of Long-Lived Assets, to include in its scope core deposit intangibles of financial institutions. Accordingly, such intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used.

The adoption of Statement No. 145, 146 and 147 did not have a material impact on the Corporation's consolidated financial statements.

The Financial Accounting Standards Board issued Statement No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of Statement No. 123, in December 2002. The Statement amends Statement No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, the Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported

results. Finally, this Statement amends APB Opinion No. 28, Interim Financial

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Reporting, to require disclosure about the effects of stock options in interim financial information. The amendments to Statement No. 123 are effective for financial statements for fiscal years ending after December 15, 2002. The amendments to APB No. 28 are effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. Early application is encouraged for both amendments. The Corporation continues to record stock options under APB Opinion No. 25, Accounting for Stock Issued to Employees, and has not adopted the alternative methods allowable under Statement No. 148. There are presently no stock options outstanding.

Item 7. Financial Statements

Pursuant to General Instruction E(2) of form 10-KSB, the information required by this Item is incorporated by reference from pages 18 to 44 of the Corporation's Annual Report to Shareholders for the fiscal year ended December 31, 2002, as follows.

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| First National Corporation and Subsidiaries: | |
| Consolidated Balance Sheets at December 31, 2002 and 2001 | 19 |
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| Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2001 and 2000 | 22-23 |
| Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2002, 2001 and 2000 | 24 |
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Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

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PART III

Item 9. Directors, Executive Officers Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

Pursuant to General Instruction E(3) of Form 10-KSB, the information contained under the headings "Election of Directors," "Nominees," "Executive Officers Who Are Not Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Corporation's Proxy Statement for the 2003 Annual Meeting of Shareholders is incorporated herein by reference.

Item 10. Executive Compensation

Pursuant to General Instruction E(3) of Form 10-KSB, the information contained under the headings "Summary of Cash and Certain Other Compensation," "Directors' Fees" and "Employment Agreement" in the Corporation's Proxy Statement for the 2003 Annual Meeting of Shareholders is incorporated herein by reference.

Item 11. Security Ownership of Certain Beneficial Owners and Management

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Pursuant to General Instruction E(3) of Form 10-KSB, the information contained under the headings "Security Ownership of Management" and "Security Ownership of Certain Beneficial Owners" in the Corporation's Proxy Statement for the 2003 Annual Meeting of Shareholders is incorporated herein by reference.

The Corporation does not have compensation plans or other arrangements under which equity securities are authorized for issuance.

Item 12. Certain Relationships and Related Transactions

Pursuant to General Instruction E(3) of Form 10-KSB, the information contained under the heading "Transactions with Management" in the Corporation's Proxy Statement for the 2003 Annual Meeting of Shareholders is incorporated herein by reference.

Item 13. Exhibits, List and Reports on Form 8-K

(a) The following documents are attached hereto or incorporated herein by reference as Exhibits:

- 3.1 Articles of Incorporation, including amendments thereto (incorporated herein by reference to Exhibit 2 to the Corporation's Form 10 filed with the SEC on May 2, 1994).
- 3.2 Bylaws (incorporated herein by reference to Exhibit 3 to the Corporation's Form 10 filed with the SEC on May 2, 1994).
- 4.1 Specimen of Common Stock Certificate (incorporated herein by reference to Exhibit 1 to the Corporation's Form 10 filed with SEC on May 2, 1994).
- 10.1 Employment Agreement, dated as of October 1, 2002, between the Corporation and Harry S. Smith.
- 13.1 Annual Report to Shareholders for the year ended December 31, 2002.
- 21.1 Subsidiaries of the Corporation (incorporated herein by reference to Exhibit 1 to the Company's Form 10-K filed with SEC on April 2, 2001).

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- 23.1 Consent of Yount, Hyde & Barbour, P.C.
- 99.1 Statement of Chief Executive Officer Pursuant to 18 U.S.C.ss.1350.
- 99.2 Statement of Chief Financial Officer Pursuant to 18 U.S.C.ss.1350.

(b) Reports on Form 8-K

No Reports on Form 8-K were filed during the quarter ended December 31, 2002.

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With the exception of the information herein expressly incorporated by reference, the 2002 Annual Report to Shareholders and the Proxy Statement for the 2003 Annual Meeting of Shareholders are not to be deemed filed as part of this Annual Report on Form 10-KSB.

Item 14. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures within 90 days of the filing date of this annual report. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and 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

Date: March 28, 2003

By: /s/ Harry S. Smith

Harry S. Smith
President and Chief Executive Officer

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.

Signature

Title

Date

/s/ Harry S. Smith

President and
Chief Executive Officer
(Principal Executive Officer)
Director

March 28, 2003

Harry S. Smith

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| | | |
|-------------------------------------------------------------|-------------------------------------------------------------------------------------------|----------------|
| /s/ Stephen C. Pettit ----- Stephen C. Pettit | Controller and Chief Financial Officer (Principal Financial and Accounting Officer) | March 28, 2003 |
| /s/ Noel M. Borden ----- Noel M. Borden | Chairman of the Board Director | March 28, 2003 |
| ----- Douglas C. Arthur | Vice Chairman of the Board Director | |
| ----- Dr. Byron A. Brill | Director | |
| /s/ Elizabeth H. Cottrell ----- Elizabeth H. Cottrell | Director | March 28, 2003 |
| ----- Dr. James A. Davis | Director | |
| ----- Christopher E. French | Director | |

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| Signature | Title | Date |
|---------------------------------------------------------------|----------|----------------|
| ----- | ----- | ---- |
| /s/ Charles E. Maddox, Jr. ----- Charles E. Maddox, Jr. | Director | March 28, 2003 |
| /s/ John K. Marlow ----- John K. Marlow | Director | March 28, 2003 |
| ----- W. Allen Nicholls | Director | |

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/s/ Henry L. Shirkey

Director

March 28, 2003

Henry L. Shirkey

Director

Alson H. Smith, Jr.

/s/ James R. Wilkins, III

Director

March 28, 2003

James R. Wilkins, III

SECTION 302 CERTIFICATION

I, Harry S. Smith, President and Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-KSB of the First National Corporation;

2. Based on my knowledge, this annual 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 annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures 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 annual report is being prepared;

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b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and

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the audit committee of registrant's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

/s/ Harry S. Smith

Harry S. Smith, President & Chief Executive Officer

SECTION 302 CERTIFICATION

I, Stephen C. Pettit, Senior Vice President and Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-KSB of First National Corporation;

2. Based on my knowledge, this annual 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 annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures 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 annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors :

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

/s/ Stephen C. Pettit

Stephen C. Pettit, Sr. Vice President
and Chief Financial Officer

EXHIBIT INDEX

| Number ----- | Document ----- |
|-----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Articles of Incorporation, including amendments thereto (incorporated herein by reference to Exhibit 2 to the Corporation's Form 10 filed with the SEC on May 2, 1994). |
| 3.2 | Bylaws (incorporated herein by reference to Exhibit 3 to the Corporation's Form 10 filed with the SEC on May 2, 1994). |
| 4.1 | Specimen of Common Stock Certificate (incorporated herein by reference to Exhibit 1 to the Corporation's Form 10 filed with SEC on May 2, 1994). |
| 10.1 | Employment Agreement, dated as of October 1, 2002, between the Corporation and Harry S. Smith. |
| 13.1 | Annual Report to Shareholders for the year ended December 31, 2002. |
| 21.1 | Subsidiaries of the Corporation (incorporated herein by reference to Exhibit 1 to the Company's Form 10-K filed with |

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SEC on April 2, 2001).

- 23.1 Consent of Yount, Hyde & Barbour, P.C.
- 99.1 Statement of Chief Executive Officer Pursuant to 18 U.S.C.ss.1350.
- 99.2 Statement of Chief Financial Officer Pursuant to 18 U.S.C.ss.1350.