SIFY TECHNOLOGIES LTD
Form 6-K
March 22, 2012

United States Securities and Exchange Commission

Washington, DC 20549

FORM 6-K

Report of Foreign Private Issuer

Pursuant to Rule 13a-16 or 15d-16 of

the Securities Exchange Act of 1934

For the quarter ended September 30, 2011

Commission File Number 000-27663

SIFY TECHNOLOGIES LIMITED

(Translation of registrant s name into English)

Tidel Park, Second Floor

No. 4, Rajiv Gandhi Salai, Taramani

Chennai 600 113, India

(91) 44-2254-0770

(Address of principal executive office)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20F x Form 40 F ¨

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b) (1).

Yes ¨ No x

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b) (7).

Yes ¨ No x

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes ¨ No x

If Yes is marked, indicate below the file number assigned to registrant in connection with Rule 12g3-2(b). Not applicable.

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SIFY TECHNOLOGIES LIMITED

FORM 6-K

For the Quarter ended September 30, 2011

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Currency of Presentation and Certain Defined Terms

Unless the context otherwise requires, references herein to we, us, the Company or Sify are to Sify Technologies Limited, a limited liability Company organized under the laws of the Republic of India. References to U.S. or the United States are to the United States of America, its territories and its possessions. References to India are to the Republic of India. In January 2003, we changed the name of our Company from Satyam Infoway Limited to Sify Limited. In October 2007, we again changed our name from Sify Limited to Sify Technologies Limited. Sify , *SifyMax.in,* , Sify e-ports and Sify online are trademarks used by us for which we have already obtained the registration certificates in India. All other trademarks or trade names used in this quarterly report are the property of their respective owners.

In this report, references to $, US$, Dollars or U.S. dollars are to the legal currency of the United States, and references to Rs. Rupees or Rupees are to the legal currency of India. References to a particular fiscal year are to our fiscal year ended March 31 of that year.

For your convenience, this report contains translations of some Indian rupee amounts into U.S. dollars which should not be construed as a representation that those Indian rupee or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Indian rupees, as the case may be, at any particular rate, the rate stated below, or at all. Except as otherwise stated in this report, all translations from Indian rupees to U.S. dollars contained in this report have been based on the reference rate in the City of Mumbai on September 30, 2011 for cable transfers in Indian rupees as published by the Reserve Bank of India (RBI) which was Rs.48.93 per $1.00.

Our financial statements are prepared in Indian rupees and presented in accordance with International Financial Reporting Standards, or IFRS as issued by International Accounting Standards Board (IASB). In this report, any discrepancies in any table between totals and the sums of the amounts listed are due to rounding.

Information contained in our websites, including our principal corporate website, *www.sifycorp.com*, is not part of this report.

Forward-looking Statements

In addition to historical information, this Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Act of 1934, as amended. The forward-looking statements contained herein are subject to risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. For a discussion of some of the risks and important factors that could affect the Company s future results and financial condition, please see the sections entitled Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations, and our Annual Report on Form 20-F for the fiscal year ended March 31, 2011, filed with the Securities and Exchange Commission (the SEC) on October 13, 2011.

The forward-looking statements contained herein are identified by the use of terms and phrases such as anticipate , believe , could , estimate , expect , intend , may , plan , objectives , outlook , probably , project , will , seek , target and similar terms and phrases. Such forv statements include, but are not limited to, statements concerning:

- our expectations as to future revenue, margins, expenses and capital requirements;
- our exposure to market risks, including the effect of foreign currency exchange rates and interest rates on our financial results;
- the effect of the international economic slowdown on our business;
- our ability to generate and manage growth and to manage our international operations;
- projections that our cash and cash equivalents, along with cash generated from operations will be sufficient to meet certain of our obligations; and
- the effect of future tax laws on our business.

You are cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this Report. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, you should carefully review the other information in this Report, our other periodic reports and other documents filed with the SEC from time to time. Our filings with the SEC are available on its website at www.sec.gov.

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Financial Position

(In thousands of Rupees, except share data and as otherwise stated)

	Note	As at September 30, 2011 Rs.	As at March 31, 2011 @ Rs.	As at September 30, 2011 Convenience translation into US$
ASSETS				
Property, plant and equipment	5	3,859,304	3,760,473	78,874
Intangible assets	6	113,999	104,626	2,330
Investment in equity accounted investee	7	738,765	702,363	15,098
Lease prepayments	9	60,530	63,068	1,237
Other assets		723,604	672,843	14,789
Other investments		160	160	3
Total non-current assets		**5,496,362**	**5,303,533**	**112,331**
Inventories		22,120	15,637	452
Trade and other receivables, net	10	3,715,452	3,185,913	75,934
Prepayments for current assets		226,422	190,191	4,627
Restricted cash	8	89,448	84,538	1,828
Cash and cash equivalents	8	458,437	458,559	9,369
Total current assets		**4,511,879**	**3,934,838**	**92,210**
Total assets		**10,008,241**	**9,238,371**	**204,541**
EQUITY AND LIABILITIES				
Equity				
Share capital		1,172,393	858,832	23,961
Share premium		17,916,443	17,216,121	366,165
Share based payment reserve		193,028	190,325	3,945
Other components of equity		20,559	7,365	420
Accumulated deficit		(13,805,487)	(13,606,851)	(282,148)
Equity attributable to equity holders of the Company		**5,496,936**	**4,665,792**	**112,343**

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Financial Position

(In thousands of Rupees, except share data and as otherwise stated)

	Note	As at September 30, 2011 Rs.	As at March 31, 2011 @ Rs.	As at September 30, 2011 Convenience translation into US$
Liabilities				
Finance lease obligations, other than current instalments		110,878	127,746	2,266
Borrowings	12	184,653	262,608	3,774
Employee benefits	11	49,119	47,788	1,004
Other liabilities		173,710	163,245	3,550
Total non-current liabilities		**518,360**	**601,387**	**10,594**
Finance lease obligations current instalments		72,889	60,507	1,490
Borrowings	12	1,036,786	1,035,802	21,189
Bank overdraft	8	220,738	678,901	4,511
Trade and other payables		2,170,394	1,783,388	44,357
Deferred income		492,138	412,594	10,057
Total current liabilities		**3,992,945**	**3,971,192**	**81,604**
Total liabilities		**4,511,305**	**4,572,579**	**92,198**
Total equity and liabilities		**10,008,241**	**9,238,371**	**204,541**

The accompanying notes form an integral part of these unaudited condensed consolidated interim financial statements

@ Derived from the audited consolidated financial statements

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Income

(In thousands of Rupees, except share data and as otherwise stated)

		Quarter ended September 30,		Quarter ended September 30, 2011	Half year ended September 30,		Half year ended September 30, 2011
	Note	2011 Rs.	2010 Rs.	Convenience translation into US$	2011 Rs.	2010 Rs.	Convenience translation into US$
Revenue	13	1,815,430	1,716,732	37,103	4,074,471	3,444,558	83,271
Cost of goods sold and services rendered	14	(1,059,720)	(1,054,062)	(21,658)	(2,616,607)	(2,128,334)	(53,477)
Other income		216	20,364	4	1,640	39,200	34
Selling, general and administrative expense		(618,689)	(608,540)	(12,644)	(1,211,630)	(1,239,557)	(24,763)
Depreciation and amortization		(171,945)	(173,353)	(3,514)	(342,454)	(347,745)	(6,999)
Impairment loss on Intangibles						(1,857)	
Loss from operating activities		**(34,708)**	**(98,859)**	**(709)**	**(94,580)**	**(233,735)**	**(1,934)**
Finance income	16	4,988	14,078	102	7,527	20,627	154
Finance expenses	16	(77,361)	(72,426)	(1,581)	(145,826)	(141,148)	(2,980)
Net finance expense		**(72,373)**	**(58,348)**	**(1,479)**	**(138,299)**	**(120,521)**	**(2,826)**
Share of profit of equity accounted investee (net of income tax)	7	18,671	22,796	382	34,243	38,488	700
Loss before tax		**(88,410)**	**(134,411)**	**(1,806)**	**(198,636)**	**(315,768)**	**(4,060)**
Income tax (expense) / benefit							
Loss for the period after tax		**(88,410)**	**(134,411)**	**(1,806)**	**(198,636)**	**(315,768)**	**(4,060)**
Loss per share	17						
Basic loss per share		(0.92)	(2.52)	(0.02)	(2.20)	(5.92)	(0.04)
Diluted loss per share		(0.92)	(2.52)	(0.02)	(2.20)	(5.92)	(0.04)

The accompanying notes form an integral part of these unaudited condensed consolidated interim financial statements

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Comprehensive Income

(In thousands of Rupees, except share data and as otherwise stated)

	Note	Quarter ended September 30 2011 Rs.	Quarter ended September 30 2010 Rs.	Quarter ended September 30, 2011 Convenience translation into US$	Half year ended September 30 2011 Rs.	Half year ended September 30 2010 Rs.	Half year ended September 30, 2011 Convenience translation into US$
Loss for the period		**(88,410)**	**(134,411)**	**(1,806)**	**(198,636)**	**(315,768)**	**(4,060)**
Other comprehensive income							
Foreign currency translation differences of foreign operations		2,660	(52)	54	2,988	(8)	61
Defined benefit plan actuarial gains / (losses)		4,009	87	82	8,045	2,821	164
Share of other comprehensive income from equity accounted investee		1,639	(175)	33	2,161	(294)	44
Other comprehensive income for the period		**8,308**	**(140)**	**169**	**13,194**	**2,519**	**269**
Total comprehensive loss for the period		**(80,102)**	**(134,551)**	**(1,637)**	**(185,442)**	**(313,249)**	**(3,791)**

The accompanying notes form an integral part of these unaudited condensed consolidated interim financial statements

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Changes in Equity

(In thousands of Rupees, except share data and as otherwise stated)

For six months ended September 30, 2011

Particulars	Share capital	Share premium	Share based payment reserve	Other components of equity	Accumulated deficit	Total Equity
Balance at April 1, 2011	**858,832**	**17,216,121**	**190,325**	**7,365**	**(13,606,851)**	**4,665,792**
Total comprehensive income/ (loss) for the period				**13,194**	**(198,636)**	**(185,442)**
Transactions with owners, recorded directly in equity						
Issue of Share Capital	313,561	700,322				1,013,883
Share-based payments			2,703			2,703
Balance at September 30, 2011	**1,172,393**	**17,916,443**	**193,028**	**20,559**	**(13,805,487)**	**5,496,936**

For six months ended September 30, 2010

Particulars	Share capital	Share premium	Share based payment reserve	Other components of equity	Accumulated deficit	Total Equity
Balance at April 1, 2010	**546,332**	**16,528,621**	**180,124**	**3,374**	**(13,087,359)**	**4,171,092**
Total comprehensive income / (loss) for the period				**2,519**	**(315,768)**	**(313,249)**
Transactions with owners, recorded directly in equity						
Share based payments			7,021			7,021
Balance at September 30, 2010	**546,332**	**16,528,621**	**187,145**	**5,893**	**(13,403,127)**	**3,864,864**

The accompanying notes form an integral part of these unaudited condensed consolidated interim financial statements.

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Cash Flows

(In thousands of Rupees, except share data and as otherwise stated)

	Six Months ended September 30		September 30, 2011 Convenience translation into US$
	2011 Rs.	2010 Rs.	
Cash flows from / (used in) operating activities			
Loss for the period	(198,636)	(315,768)	(4,060)
Adjustments for:			
Depreciation and amortization	342,454	347,745	6,999
Impairment loss on Intangibles including goodwill		1,857	
Share of profit of equity accounted investee	(34,243)	(38,488)	(700)
Loss / (gain) on sale of property, plant and equipment	(83)	1,178	(2)
Provision for doubtful receivables and advances	32,201	69,777	658
Customs duty credit entitlement written off	20,000		409
Stock compensation expense	2,703	7,021	55
Net finance expense / (income)	138,299	120,521	2,826
Unrealized (gain) / loss on account of exchange differences	(5,804)	(9,668)	(119)
Amortisation of Leasehold Prepayments	2,497	1,964	51
	299,388	**186,139**	**6,117**
Change in trade and other receivables	(565,769)	(251,487)	(11,563)
Change in inventories	(6,483)	(3,666)	(132)
Change in other assets	(56,780)	9,909	(1,160)
Change in trade and other payables	340,540	283,303	6,960
Change in employee benefits	9,376	11,595	192
Change in deferred revenue	79,544	61,690	1,626
	99,816	297,483	2,040
Income taxes paid	23,639	(13,130)	482
Net cash from / (used in) operating activities	**123,455**	**284,353**	**2,522**
Cash flows from / (used in) investing activities			
Acquisition of property, plant and equipment	(340,308)	(148,889)	(6,955)
Expenditure on intangible assets	(46,782)	(71,812)	(956)
Proceeds from sale of property, plant and equipment	323	1,549	7
Finance income received	4,646	35,898	95
Other investments		(150)	
Net cash used in investing activities	**(382,121)**	**(183,404)**	**(7,809)**

Sify Technologies Limited

Unaudited Condensed Consolidated Interim Statement of Cash Flows

(In thousands of Rupees, except share data and as otherwise stated)

	Six months ended September 30		September 30, 2011 Convenience translation into US$
	2011 Rs	2010 Rs	
Cash flows from / (used in) financing activities			
Proceeds from issue of shares on private placement (including share premium)	1,000,000		20,437
Proceeds from issue of shares on exercise of options (including share premium)	13,883		284
Proceeds from / (repayment of) borrowings, net	(95,936)	(142,372)	(1,961)
Finance expenses paid	(158,397)	(150,233)	(3,237)
Repayment of finance lease liabilities	(34,842)	(23,541)	(712)
Net cash from / (used) in financing activities	**724,708**	**(316,146)**	**14,811**
Net decrease in cash and cash equivalents	**442,042**	**(215,197)**	**9,524**
Cash and cash equivalents at April 1	(135,804)	(181,586)	(2,775)
Effect of exchange fluctuations on cash held	(3,091)	1,375	(63)
Cash and cash equivalents at period end	**327,147**	**(395,408)**	**6,686**
Supplementary information			
Additions to property plant and equipment represented by finance lease obligations	30,356	30,836	620

The accompanying notes form an integral part of these unaudited condensed consolidated interim financial statements

SIFY TECHNOLOGIES LIMITED

UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(In thousands of Rupees, except share, per share data and as stated otherwise)

1. Reporting entity

Sify Technologies Limited, (Sify or the Company) formerly known as Sify Limited, is a leading internet services provider headquartered in Chennai, India. These Unaudited Condensed Consolidated Interim Financial Statements as at and for the three months and six months ended September 30, 2011 comprise the Company and its subsidiaries (Sify Software Limited, Sify International Inc and Sify Technologies (Singapore) Pte Limited) (together referred to as the Group and individually as Group entities) and the Group s interest in MF Global Sify Securities India Private Limited, an equity accounted investee. The Group is primarily involved in providing services, such as Corporate Network and Data Services, Internet Access Services, Online Portal and Content offerings and in selling hardware and software related to such services. Sify is listed on the NASDAQ Global Select market in the United States.

2. Basis of preparation

a. Statement of compliance

The Unaudited Condensed Consolidated Interim Financial Statements of the Group have been prepared in accordance with International Financial Reporting Standard (IFRS), *IAS 34 Interim Financial Reporting*. They do not include all of the information required for full annual financial statements, and should be read in conjunction with the consolidated financial statements of the Group as at and for the year ended March 31, 2011.

These Unaudited Condensed Consolidated Interim Financial Statements have been approved for issue by the Board of Directors on March 21, 2012.

b. Functional and presentation currency

Items included in the financial statements of each Group entity are measured using the currency of the primary economic environment in which the entity operates (the functional currency). Indian rupee is the functional currency of Sify, its domestic subsidiaries and affiliates. US dollar is the functional currency of Sify s foreign subsidiary located in the US and Singapore.

The Unaudited Condensed Consolidated Interim Financial Statements are presented in Indian Rupees which is the Group s presentation currency. All financial information presented in Indian Rupees has been rounded up to the nearest thousand except where otherwise indicated.

Convenience translation: Solely for the convenience of the reader, the financial statements as of and for the three months and six months ended September 30, 2011 have been translated into United States dollars (neither the presentation currency nor the functional currency) based on the reference rate in the City of Mumbai on September 30, 2011, for cable transfers in Indian rupees as published by the Reserve Bank of India which was Rs.48.93 per $1.00. No representation is made that the Indian rupee amounts have been, could have been or could be converted into United States dollar at such a rate or at any other rate on September 30, 2011 or at any other date.

c. Use of estimates and judgements

The preparation of these Unaudited Condensed Consolidated Interim Financial Statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses during the period. Accounting estimates could change from period to period. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period of change and future periods, if the change affects both and, if material, their effects are disclosed in the notes to the financial statements.

In preparing the Unaudited Condensed Consolidated Interim Financial Statements, the significant judgements made by management in applying the Group s accounting policies and key sources of estimating uncertainties were the same as that were applied to the consolidated financial statements as at and for the year ended March 31, 2011.

3. Significant accounting policies

The accounting policies applied by the group in these Unaudited Condensed Consolidated Interim Financial Statements are the same as those applied by the Group in its consolidated financial statements as at and for the year ended March 31 2011.

4. Recent accounting pronouncements

A number of new standards, amendments to standards and interpretations are not yet effective for the period ended September 30, 2011, and have not been applied in preparing these consolidated financial statements:

IFRS 9 Financial Instruments: In November 2009, the International Accounting Standards Board issued IFRS 9, Financial Instruments: Recognition and Measurement, to reduce the complexity of the current rules on financial instruments as mandated in IAS 39. The effective date for IFRS 9 is annual periods beginning on or after January 1, 2013 with early adoption permitted. IFRS 9 has fewer classification and measurement categories as compared to IAS 39 and has eliminated the categories of held to maturity, available for sale and loans and receivables. Further it eliminates the rule-based requirement of segregating embedded derivatives and tainting rules pertaining to held to maturity investments. For an investment in an equity instrument which is not held for trading, IFRS 9 permits an irrevocable election, on initial recognition, on an individual share-by-share basis, to present all fair value changes from the investment in other comprehensive income. No amount recognized in other comprehensive income would ever be reclassified to profit or loss. IFRS 9, was further amended in October 2010, and such amendment introduced requirements on accounting for financial liabilities. This amendment addresses the issue of volatility in the profit or loss due to changes in the fair value of an entity s own debt. It requires the entity, which chooses to measure a liability at fair value, to present the portion of the fair value change attributable to the entity s own credit risk in the other comprehensive income. The company is required to adopt IFRS 9 by accounting year commencing April 1, 2013. The company is currently evaluating the requirements of IFRS 9, and has not yet determined the impact on the consolidated financial statements.

IFRS 10, Consolidated Financial Statements, IFRS 11, Joint Arrangements and IFRS 12, Disclosure of Interests in Other Entities:

In May 2011, the International Accounting Standards Board issued IFRS 10, IFRS 11 and IFRS 12. The effective date for IFRS 10, IFRS 11 and IFRS 12 is annual periods beginning on or after January 1, 2013 with early adoption permitted.

IFRS 10 Consolidated Financial Statements builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. IFRS 10 replaces the consolidation requirements in SIC-12 Consolidation of Special Purpose Entities and IAS 27 Consolidated and Separate Financial Statements. The standard provides additional guidance for determining of control in cases of ambiguity for instance in case of franchisor franchisee relationship, de facto agent, silos and potential voting rights.

IFRS 11 Joint Arrangements determines the nature of an arrangement by focusing on the rights and obligations of the arrangement, rather than its legal form. IFRS 11 replaces IAS 31 Interests in Joint Ventures and SIC-13 Jointly-controlled Entities-Non-monetary Contributions by Venturers. IFRS 11 addresses only forms of joint arrangements (joint operations and joint ventures) where there is joint control whereas IAS 31 had identified three forms of joint ventures, namely jointly controlled operations, jointly controlled assets and jointly controlled entities. The standard addresses inconsistencies in the reporting of joint arrangements by requiring a single method to account for interests in jointly controlled entities, which is the equity method.

IFRS 12 Disclosure of Interests in Other Entities is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles and other off balance sheet vehicles. One major requirement of IFRS 12 is that an entity needs to disclose the significant judgments and assumptions it has made in determining:

- whether it has control, joint control or significant influence over another entity; and

- the type of joint arrangement when the joint arrangement is structured through a separate vehicle.

IFRS 12 also expands the disclosure requirements for subsidiaries with non-controlling interest, joint arrangements and associates that are individually material. IFRS 12 introduces the term structured entity by replacing Special Purpose entities and requires enhanced disclosures by way of nature and extent of, and changes in, the risks associated with its interests in both its consolidated and unconsolidated structured entities.

The company is required to adopt IFRS 10, IFRS 11 and IFRS 12 effective April 1, 2013. The company is currently evaluating the requirements of IFRS 10, IFRS 11 and IFRS 12, and has not yet determined the impact on the consolidated financial statements.

IFRS 13 Fair Value Measurement: In May 2011, the International Accounting Standards Board issued IFRS 13, Fair Value Measurement to provide specific guidance on fair value measurement and requires enhanced disclosures for all assets and liabilities measured at fair value, and not restricted to financial assets and liabilities. The standard introduces a precise definition of fair value and a consistent measure for fair valuation across assets and liabilities, with a few specified exceptions. The effective date for IFRS 13 is annual periods beginning on or after January 1, 2013 with early adoption permitted. The company is required to adopt IFRS 13 by accounting year commencing April1, 2013 and is currently evaluating the requirements of IFRS 13, and has not yet determined the impact on the consolidated financial statements.

IAS 1 (Amended) Presentation of Financial Statements: In June 2011, the International Accounting Standard Board published amendments to IAS 1 Presentation of Financial Statements. The amendments to IAS 1 Presentation of Financial Statements require companies preparing financial statements in accordance with IFRS to group items within other comprehensive income that may be reclassified to the profit or loss separately from those items which would not be recyclable in the profit or loss section of the income statement. It also requires the tax associated with items presented before tax to be shown separately for each of the two groups of other comprehensive income items (without changing the option to present items of other comprehensive income either before tax or net of tax).

The amendments also reaffirm existing requirements that items in other comprehensive income and profit or loss should be presented as either a single statement or two consecutive statements. This amendment is applicable to annual periods beginning on or after July 1, 2012, with early adoption permitted. The company is required to adopt IAS 1 (Amended) by accounting year commencing April 1, 2013. The company has evaluated the requirements of IAS 1 (Amended) and the company does not believe that the adoption of IAS 1 (Amended) will have a material effect on its consolidated financial statements.

IAS 19 (Amended) Employee Benefits: In June 2011, International Accounting Standards Board issued IAS 19 (Amended), Employee Benefits. The effective date for adoption of IAS 19(Amended) is annual periods beginning on or after January 1, 2013, though early adoption is permitted.

IAS 19 (Amended) has eliminated an option to defer the recognition of gains and losses through re-measurements and requires such gain or loss to be recognized through other comprehensive income in the year of occurrence to reduce volatility. The amended standard requires immediate recognition of effects of any plan amendments. Further it also requires assets in profit or loss to be restricted to government bond yields or corporate bond yields, considered for valuation of Projected Benefit Obligation, irrespective of actual portfolio allocations. The actual return from the portfolio in excess of or less than such yields is recognized through other comprehensive income.

These amendments enhance the disclosure requirements for defined benefit plans by requiring information about the characteristics of defined benefit plans and risks that entities are exposed to through participation in those plans.

The amendments need to be adopted retrospectively. The company is required to adopt IAS 19 (Amended) by accounting year commencing April 1, 2013. The company is currently evaluating the requirements of IAS 19 (Amended) and has not yet determined the impact on the consolidated financial statements.

5. Property, plant and equipment

The following table presents the changes in property, plant and equipment during the six months ended September 30, 2011

	Cost				Accumulated depreciation				
Particulars	**As at April 1, 2011**	**Additions**	**Disposals**	**As at September 30, 2011**	**As at April 1, 2011**	**Depreciation for the period**	**Deletions**	**As at September 30, 2011**	**Carrying amount as at September 30, 2011**
Building	777,419			777,419	204,826	13,877		218,703	558,716
Plant and machinery	5,433,359	128,575	25,904	5,536,030	3,335,610	249,488	25,772	3,559,326	1,976,704
Computer equipment	563,776	27,493	361	590,908	478,705	16,209	343	494,571	96,337
Office equipment	234,125	104	25	234,204	129,932	10,655	25	140,562	93,642
Furniture and fittings	713,359	2,521	1,336	714,544	503,102	30,456	1,189	532,369	182,175
Vehicles	2,929	2,907	1,089	4,747	2,929	323	1,089	2,163	2,584
Total	**7,724,967**	**161,600**	**28,715**	**7,857,852**	**4,655,104**	**321,008**	**28,418**	**4,947,694**	**2,910,158**
Add: Construction -in-Progress									949,146
Total	**7,724,967**	**161,600**	**28,715**	**7,857,852**	**4,655,104**	**321,008**	**28,418**	**4,947,694**	**3,859,304**

The following table presents the changes in property, plant and equipment during the year ended March 31, 2011

	Cost				Accumulated depreciation				
Particulars	**As at April 01, 2010**	**Additions**	**Disposals**	**As at March 31, 2011**	**As at April 1, 2010**	**Depreciation for the year**	**Deletions**	**As at March 31, 2011**	**Carrying amount as at March 31, 2011**
Building	777,419			777,419	177,072	27,754		204,826	572,593
Plant and machinery	5,302,696	199,591	68,928	5,433,359	2,929,688	474,168	68,246	3,335,610	2,097,749
Computer equipments	517,904	46,736	864	563,776	429,631	49,854	780	478,705	85,071
Office equipment	228,418	6,214	507	234,125	107,252	23,181	501	129,932	104,193
Furniture and fittings	706,148	15,731	8,520	713,359	445,437	64,442	6,777	503,102	210,257
Vehicles	6,191		3,262	2,929	6,191		3,262	2,929	
Total	**7,538,776**	**268,272**	**82,081**	**7,724,967**	**4,095,271**	**639,399**	**79,566**	**4,655,104**	**3,069,863**
Add: Construction in Progress									690,610
Total	**7,538,776**	**268,272**	**82,081**	**7,724,967**	**4,095,271**	**639,399**	**79,566**	**4,655,104**	**3,760,473**

Leased assets

The Group s leased assets include certain buildings and plant and machinery acquired under finance leases. As at September 30, 2011 the net carrying amount of buildings, vehicles and plant and machinery acquired under finance leases is Rs 239,767 (March 31, 2011: Rs.244,926), Rs.2,584 (March 31, 2011 : Nil) and Rs.223,689 (March 31, 2011: Rs. 217,625) respectively. During the period, the Group acquired leased assets of Rs.30,356 (March 31, 2011: Rs 38,111)

Construction-in-progress

Amounts paid towards acquisition of property, plant and equipment outstanding at each balance sheet date and the cost of property, plant and equipment that are not ready for use are disclosed under construction-in-progress. As of September 30, 2011, Construction work in progress includes Rs.909,825 (March 31, 2011 : 682,825) paid towards acquisition of leasehold land together with the building being constructed thereon belonging to Pace Info Com Park Private Limited by way of acquisition of the entire shareholding of its holding company M/s Hermit Projects Private Limited. Also refer note 23.

6. Intangible assets

Intangible assets comprise the following:

	As at September 30, 2011	**As at March 31, 2011**
Goodwill	14,595	14,595
Other Intangibles	99,404	90,031
Total	**113,999**	**104,626**

In May 2006, the group acquired travel business for a consideration of USD 2.5 million (Rs. 112,220 thousands) in cash along with an option to purchase 125,000 shares of Sify Technologies Limited and certain earn out payments aggregating to USD 0.5 million (Rs. 22,444 thousands). The assets acquired consist of System software, customer contracts and goodwill. The said business operated from India and United States.

During the six months ended September 30, 2010, triggered by certain adverse market conditions such as decrease in revenue and increase in the cost of services, continued losses and other technological matters, which are confirmed by other subsequent events, the group tested the carrying value of the above business for impairment. The recoverable amount of these intangibles were determined based on the higher of the value in use (using discounted cash flow approach) and fair value less cost to sell. As a result of the above review, the group has recorded an impairment of the above intangibles amounting to Rs 1,857 and adjusted the carrying value of these intangibles accordingly. The above impairment relates to Commercial and Consumer Services segment.

The following table presents the changes in goodwill during the six months ended September 30, 2011 and the year ended March 31, 2011

(i) Goodwill

Particulars	**As at September 30, 2011**	**As at March 31, 2011**
Balance at the beginning of the period / year	14,595	14,595
Less: Impairment loss		
Net carrying amount of goodwill	**14,595**	**14,595**

The amount of goodwill as at September 30, 2011 and March 31, 2011 has been allocated to Commercial and Consumer Services Segment.

(ii) Other Intangibles

The following table presents the changes in other intangible assets for the six months ended September 30, 2011 and year ended March 31, 2011.

	Technical know-how	Customer related intangibles	Software	License fees	Total
(A) Cost					
Balance as at April 1, 2011	**82,753**	**200,570**	**394,080**	**50,000**	**727,403**
Other acquisitions			30,819		30,819
Deletions					
Balance as at September 30, 2011	**82,753**	**200,570**	**424,899**	**50,000**	**758,222**
(B) Amortization					
Balance as at April 1, 2011	**82,753**	**200,570**	**343,143**	**10,906**	**637,372**
Amortization for the period			20,196	1,250	21,446
Impairment loss on intangibles					
Deletions					
Balance as at September 30, 2011	**82,753**	**200,570**	**363,339**	**12,156**	**658,818**
(C) Carrying amount as at September 30, 2011			**61,560**	**37,844**	**99,404**
(A) Cost					
Balance as at April 1, 2010	**82,753**	**200,570**	**370,683**	**50,000**	**704,006**
Other acquisitions			23,397		23,397
Deletions					
Balance as at March 31, 2011	**82,753**	**200,570**	**394,080**	**50,000**	**727,403**
(B) Amortization					
Balance as at April 1, 2010	**82,753**	**198,139**	**299,779**	**8,406**	**589,077**
Amortization for the period		837	43,101	2,500	46,438
Impairment loss on intangibles		1,594	263		1,857
Deletions					
Balance as at March 31, 2011	**82,753**	**200,570**	**343,143**	**10,906**	**637,372**
(C) Carrying amount as at March 31, 2011			**50,937**	**39,094**	**90,031**

During the six months ended September 30, 2010, the Group has impaired intangible assets relating to its travel business to the extent of Rs.1,857. The above impairment loss related to Commercial and Consumer Services segment.

7. Investments in associates

In March 2006, MF Global Overseas Limited (MFG), a Group incorporated in United Kingdom acquired 70.15% of equity share capital of MF Global Sify Securities India Private Limited, formerly Man Financial-Sify Securities India Private Limited (MF Global) from Refco Group Inc., USA (Refco). As at September 30, 2011 and March 31, 2011, 29.85% of MF Global equity shares is held by the Company. The remaining 70.15% is owned by MFG, an unrelated third party. MFG is a subsidiary of MF Global Holdings Limited, Bermuda.

A summary of key unaudited financial information of MF Global and its subsidiaries which is not adjusted for the percentage ownership held by the Group is presented below:

	As at September 30, 2011	**As at March 31, 2011**
Balance sheet		
Total assets	5,039,711	4,546,919
Total liabilities	2,564,781	2,193,943
Shareholders equity	2,474,930	2,352,976
Total liabilities and shareholders equity	5,039,711	4,546,919

	Three months ended		**Half year ended**	
	September 30, 2011	**September 30, 2010**	**September 30, 2011**	**September 30, 2010**
Statement of Operations				
Revenues	402,264	488,076	777,093	919,191
Net Profit	62,548	76,367	114,717	128,938

During October 2010, Sify Technologies Ltd, the minority shareholder of MF Global holding 29.85 percent of the outstanding shares, requested MF Global s Board of Directors to reconsider certain costs charged to the MF Global by MF Global Holdings Ltd and its affiliated and associated group companies, who hold 70.15 percent of the outstanding shares of the MF Global. These charges are currently recorded in the financial statements of the MF Global for year ended March 31, 2008 aggregating to INR 43,478,911 and March 31, 2009 aggregating to INR 15,374,528. The resolution of this matter between the shareholders of MF Global remains uncertain and any financial adjustment that may arise is not presently known and accordingly no adjustment related to this matter has been provided for in MF Global s consolidated financial statements. Any financial adjustment that may arise on resolution of the said matter would be expected to be handled prospectively and therefore would be reported in the period in which it is resolved. Consequently, no adjustment related to the said matter was considered by Sify for equity method of accounting for MF Global. The effect of such recorded cross charge is not material to the financial statements of Sify Technologies Limited. Also refer to note 23 elsewhere in the Report.

8. Cash and cash equivalents

Cash and cash equivalents as at September 30, 2011 amounted to Rs.458,437 (Rs.458,559 as at March 31, 2011). This excludes cash-restricted of Rs.89,448 as at September 30, 2011 (Rs.84,538 as at March 31, 2011) representing deposits held under lien against working capital facilities availed and bank guarantees given by the Group towards future performance obligations.

(a) Restricted cash

	As at September 30, 2011	As at March 31, 2011	As at September 30, 2010	As at March 31, 2010
Non-current				
Against future performance obligation				
Current				
Bank deposits held under lien against borrowings from banks	89,448	84,538	440,941	360,909
Total restricted cash	**89,448**	**84,538**	**440,941**	**360,909**
(b) Non restricted cash				
Current				
Cash and bank balances	**458,437**	**458,559**	**303,318**	**517,789**
Total cash (a+b)	**547,886**	**543,097**	**744,259**	**878,698**
Bank overdraft used for cash management purposes	(220,738)	(678,901)	(1,139,667)	(1,060,284)
Cash and cash equivalents for the statement of cash flows	**(327,147)**	**(135,804)**	**(395,408)**	**(181,586)**

9. Lease prepayments

	As at September 30, 2011	As at March 31, 2011
Towards buildings	60,530	63,068
	60,530	**63,068**

Prepayments made towards buildings accounted for as operating leases are amortised over the lease term on a straight line basis.

10. Trade and other receivables

Trade and other receivables comprise:

	As at September 30, 2011	As at March 31, 2011
(i) Trade receivables, net	2,326,899	1,839,966
(ii) Other receivables including deposits	1,083,304	1,251,690
(iii) Construction Contract in Progress	305,249	94,257
	3,715,452	**3,185,913**

Trade receivable as at September 30, 2011 and March 31, 2011 are stated net of allowance for doubtful receivables. The Group maintains an allowance for doubtful receivables based on its age and collectability. Trade receivables are not collateralised except to the extent of refundable deposits received from cybercafé franchisees and from cable television operators. Trade receivables consist of:

	As at September 30, 2011	**As at March 31, 2011**
Trade receivables from related parties		
Due from customers	2,554,859	2,055,974
	2,554,859	**2,055,974**
Less: Allowance for doubtful receivables	(227,960)	(216,008)
Balance at the end of the period	**2,326,899**	**1,839,966**

The activity in the allowance for doubtful accounts receivable is given below:

	Half year ended September 30, 2011	As at March 31, 2011
Balance at the beginning of the period	216,008	170,706
Add : Additional provision	32,201	161,922
Less : Bad debts written off	(20,249)	(116,620)
Balance at the end of the period	**227,960**	**216,008**

11. Employee benefits

	As at September 30, 2011	As at March 31, 2011
Gratuity payable	19,783	19,116
Compensated absences	29,336	28,672
	49,119	**47,788**

Gratuity cost

The components of gratuity cost recognized in the income statement for the three months and six months ended September 30, 2011 and 2010 consists of the following:

	Three months ended September 30, 2011	Three months ended September 30, 2010	Half year ended September 30, 2011	Half year ended September 30, 2010
Service cost	3,973	3,906	7,946	6,243
Interest cost	1,141	1,543	2,319	2,515
Expected returns on plan assets	(758)	(864)	(1,553)	(1,540)
Past service cost		1,047		7,789
Net gratuity costs recognized in statement of income	**4,356**	**5,632**	**8,712**	**15,007**

Details of employee benefit obligations and plan assets are as follows:

	September 30, 2011	March 31, 2011
Present value of projected benefit obligation at the end of the period / year	58,555	59,571
Funded status of the plans	(38,772)	(40,455)
Liability recognized in the statement of financial position	**19,783**	**19,116**

The following table set out the status of the gratuity plan:

	September 30, 2011	March 31, 2011
Change in projected benefit obligation		
Projected benefit obligation at the beginning of the period / year	59,571	51,046
Service cost	7,946	22,275
Interest cost	2,319	3,786
Actuarial (gain)/ loss	(8,045)	(8,358)
Benefits paid	(3,236)	(9,178)
Projected benefit obligation at the end of the period / year	**58,555**	**59,571**

	September 30, 2011	March 31, 2011
Change in plan assets		
Fair value of plan assets at the beginning of the period / year	40,455	34,293
Expected return on plan assets	1,553	2,875
Employer contributions		12,465
Benefits paid	(3,236)	(9,178)
Fair value of plan assets at the end of the period / year	**38,772**	**40,455**

Actuarial Assumptions at reporting date:

	As at September 30, 2011	As at March 31, 2011
Discount rate	8.30% p.a	8.00% p.a
Long-term rate of compensation increase	8.00% p.a	8.00% p.a
Rate of return on plan assets	8.00% p.a	8.00% p.a

The Group assesses these assumptions with the projected long-term plans of growth and prevalent industry standards.

Actuarial gains and losses recognised in other comprehensive income

The amount of actuarial gains and losses recognized directly in other comprehensive income for the six months ended September 30, 2011 and 2010 are as follows:

	Half year ended September 30, 2011	Half year ended September 30, 2010
Actuarial gain / (loss)	8,045	2,821
	8,045	**2,821**

12. Borrowings

	September 30, 2011	March 31, 2011
Current		
Term loans from banks (Refer note 1 below)	220,966	216,000
Other working capital facilities from banks (Refer note 2 below)	650,103	679,542
Loan from other financial institutions (Refer note 3 below)	165,717	140,260
	1,036,786	**1,035,802**
Non current		
Term loans from banks		113,880
Loan from other financial institutions (Refer note 3 below)	184,653	148,728

	184,653	**262,608**

Notes

1. Term loans from banks are secured by moveable fixed assets of the Group. These loans bear interest ranging from 14.50% to 16.50% p.a.

2. Other working capital facilities are secured by pari-passu charge on current assets of the Company and moveable assets of the company, both present and future. Foreign currency demand loan bears an interest of 650 bps over one year USD Libor. Other working capital borrowings bear interest ranging from 13.50% to 15.50% p.a. Such facilities are renewable every year.

3. Loan from other financial institutions includes loan are secured against specific fixed assets.

13. Revenue

	Quarter ended		Half year ended	
	September 30, 2011	**September 30, 2010**	**September 30, 2011**	**September 30, 2010**
Rendering of services				
Service revenue	1,419,432	1,367,938	2,784,926	2,601,237
Initial franchisee fees	1,644	3,615	4,326	5,146
Installation service revenue	310,151	173,260	591,050	402,845
	1,731,227	**1,544,813**	**3,380,302**	**3,009,228**
Sale of products	84,203	171,919	435,329	435,330
Total	**1,815,430**	**1,716,732**	**4,074,471**	**3,444,558**

14. Cost of goods sold and services rendered

Cost of goods sold and services rendered information is presented before any depreciation or amortization that is direct and attributable to revenue sources. The Group s asset base deployed in the business is not easily split into a component that is directly attributable to a business and a component that is common / indirect to all the businesses. Since a gross profit number without depreciation and amortization does not necessarily meet the objective of such a disclosure, the Group has not disclosed gross profit numbers but disclosed all expenses, direct and indirect, in a homogenous group leading directly from revenue to operating margin.

15. Personnel expenses

	Quarter ended		Half year ended	
	September 30, 2011	**September 30, 2010**	**September 30, 2011**	**September 30, 2010**
Salaries and wages	334,928	295,819	648,886	600,343
Contribution to provident fund and other funds	14,789	16,922	28,940	41,598
Staff welfare expenses	3,415	3,223	7,885	7,810
Employee Stock compensation expense	1,484	4,483	2,703	7,020
	354,616	**320,447**	**688,414**	**656,771**
Attributable to Cost of goods sold and services rendered	227,888	221,041	451,174	424,475

Attributable to selling, general and administrative expenses	126,728	99,406	237,240	232,296

16. Net finance income and expense

	Quarter ended		Half year ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
Interest income on bank deposits	4,100	12,610	5,795	17,791
Others	888	1,468	1,732	2,836
Finance income	**4,988**	**14,078**	**7,527**	**20,627**
Interest expense on financial liabilities leases	6,828	5,229	12,455	9,269
Bank charges	37,047	25,080	73,506	48,820
Other interest	33,486	42,117	59,865	83,059
Finance expense	**77,361**	**72,426**	**145,826**	**141,148**
Net finance income / (expense) recognised in profit or loss	**(72,373)**	**(58,348)**	**(138,299)**	**(120,521)**

17. Loss per share

The calculation of basic loss per share for the quarter and half year ended September 30, 2011 and 2010 is based on the loss attributable to ordinary shareholders.

	Quarter ended		Half year ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
Net profit / (loss) as reported	(88,410)	(134,411)	(198,636)	(315,768)
Weighted average number of shares Basic and diluted *	95,906,307	53,351,498	90,302,450	53,351,498
Basic earnings /(loss) per share	(0.92)	(2.52)	(2.20)	(5.92)

* Ordinary shares arising out of potential exercise of outstanding stock options as at September 30, 2011 and 2010 were not included in the computation of diluted earnings per share, as their effect was anti-dilutive.

Note 1: During the year ended March 31, 2011, 125,000,000 ordinary shares were issued to the existing promoter group on a private placement basis. As of September 30, 2011, these shares were partly paid up to the extent of Rs 5.00 per share.

18. Segment reporting

There has been change in the composition of reportable segments for the six months ended September 30, 2011 as compared to the year ended March 31, 2011.

Effective April 1, 2011, the primary operating segments of the Group are as below:

Enterprise Service: This segment includes Network Services and IT services. Connectivity and voice services will be offered as Network Services, while Data Center Hosting and Managed Services, along with System Integration, will comprise IT services. This segment would service both domestic and International clients from large corporate and mid-market customers.

Commercial and Consumer Service: The scope of the Consumer business is being expanded to include SOHOs and SMBs apart from the cybercafés, Portals and broadband-to-home services, offering network, IT services and applications through the Cloud.

Software Service: The application services and e-learning would form Software services. This business line will offer applications through the Cloud, primarily targeted at enterprise and international customers.

Enterprise Services

Enterprise services revenue primarily includes Network services and IT services. Network Services include revenues from connectivity services such as recurring revenues, installation of the connectivity link, and, to a lesser extent, revenue from sale of hardware and software purchased from third party vendors and Voice services viz., NLD (National Long Distance) and ILD (International Long Distance) services carrying voice traffic for carriers. Connectivity services include IP VPN services, Internet connectivity, and last mile connectivity (predominantly through wireless). IT Services includes web hosting revenues, primarily generated from co-location services and Managed services including infrastructure management services offered in overseas markets and System Integration services, security and consulting services. Sify, part of international offering, offers Network management services, Data center services, Security and information assurance services. Sify remotely manages the Information Technology infrastructure of global enterprises from India.

Commercial and consumer Retail Internet access services and Online Portal and content offerings

Internet access service revenues are generated from providing internet connectivity to our retail customers through public access and home access services which are primarily provided through broadband connectivity in arrangement with Cable Television Operators (CTOs). Our public access services with host of value added services are provided through franchised and Company-owned cybercafés, or e-ports . Additionally, we generate revenue by providing Internet Telephony services, allowing customers to make international telephone calls over the Internet. We also offer the premium broadband connection, branded Platinum to the SOHO market segment including domain names, e mail Ids, static IP

Online portal services and content offerings revenues include advertising revenues from the various channels of our Internet portal, www.sify.com. We enter into contracts with customers to serve advertisements in the portal, and we are paid on the basis of impressions, click-through or leads.

Software services

Our software services offer Application management services and e Learning services. As part of Application management services we offer online assessment, Document management services, web development and mailing solutions. E-learning services consist of structuring of contents, developing modules, delivery and training users in the modules developed. As these activities represent development of customised services, revenue is recognised based on percentage of completion method.

Quarter ended September 30, 2011

	Enterprise Services	**Commercial and Consumer Services**	**Software Services**	**Total**
Segment revenue	1,544,353	95,246	175,831	1,815,430
Allocated segment expenses	(1,232,057)	(57,338)	(153,192)	(1,442,587)
Segment operating income / (loss)	**312,296**	**37,908**	**22,639**	**372,843**
Unallocated expenses				
Selling, general and administrative expenses				(235,822)
Depreciation and amortization				(171,945)
Other income / (expense), net				216
Finance income				4,988
Finance expenses				(77,361)
Share of profit of equity accounted investee				18,671
Profit or (Loss) before Tax				**(88,410)**
Income tax(expense)/benefit				

Profit/(loss) for the quarter	**(88,410)**

Quarter ended September 30, 2010

	Enterprise Services	Commercial and Consumer Services	Software Services	Total
Segment revenue	1,436,144	136,090	144,498	1,716,732
Allocated segment expenses	(1,145,423)	(180,972)	(120,385)	(1,446,780)
Segment operating income / (loss)	**290,721**	**(44,882)**	**24,113**	**269,952**
Unallocated expenses				
Selling, general and administrative expenses				(215,822)
Depreciation and amortization				(173,353)
Other income / (expense), net				20,364
Finance income				14,078
Finance expenses				(72,426)
Share of profit of equity accounted investee				22,796
Profit or (Loss) before Tax				**(134,411)**
Income tax(expense)/benefit				
Profit/(loss) for the quarter				**(134,411)**

Six months ended September 30, 2011

	Enterprise Services	Commercial and Consumer Services	Software Services	Total
Segment revenue	3,547,337	195,465	331,669	4,074,471
Allocated segment expenses	(2,956,093)	(120,812)	(296,185)	(3,373,090)
Segment operating income / (loss)	**591,244**	**74,653**	**35,484**	**701,381**
Unallocated expenses				
Selling, general and administrative expenses				(455,147)
Depreciation and amortization				(342,454)
Other income / (expense), net				1,640
Finance income				7,527
Finance expenses				(145,826)
Share of profit of equity accounted investee				34,243
Profit or (Loss) before Tax				**(198,636)**
Income tax(expense)/benefit				
Profit/(loss) for the quarter				**(198,636)**

Six months ended September 30, 2010

	Enterprise Services	Commercial and Consumer Services	Software Services	Total
Segment revenue	2,878,201	280,029	286,328	3,444,558
Allocated segment expenses	(2,307,866)	(369,593)	(249,036)	(2,926,495)
Segment operating income / (loss)	**570,335**	**(89,564)**	**37,292**	**518,063**
Unallocated expenses				
Selling, general and administrative expenses				(441,396)
Depreciation and amortization				(347,745)
Impairment loss on Intangibles including goodwill				(1,857)
Other income / (expense), net				39,200
Finance income				20,627
Finance expenses				(141,148)
Share of profit of equity accounted investee				38,488
Profit or (Loss) before Tax				**(315,768)**
Income tax(expense)/benefit				
Profit/(loss) for the six months period				**(315,768)**

As the revenue with a single external customer during the six months ended September 30, 2011 and 2010 did not exceed 10% of the Company s revenue for the respective periods, the disclosure regarding the revenue from major customers and identity and segment generating such revenue is not provided.

19. Capital Commitments

Contracts pending to be executed on capital account as at September 30, 2011 and not provided for amounted to Rs.311,878 (net of advances Rs.948,837), [March 31, 2011 Rs.521,562 (net of advances Rs,691,338). In addition, the Company has a commitment to make payments aggregating to USD 10 million to Emirates Integrated Telecommunications Company PJSC under the agreement for supply of capacity from the Europe India Gateway, of which the Company has already made payments amounting to Rs.410,609 (USD 8.80 million) as at September 30, 2011.

Operating leases: The Group leases office buildings and other equipments under operating lease arrangements that are renewable on a periodic basis at the option of both the Lessor and the lessee. The schedule of future minimum rental payments in respect of operating leases is set out below:

Non-cancellable operating lease obligations	Total	Less than 1 year	1-5 years	More than 5 years
As at September 30, 2011	1,833,032	108,701	471,706	1,252,625
As at March 31, 2011	1,884,543	105,693	588,973	1,189,877

20. Legal proceedings

(a) The Group and certain of its officers and directors are named as defendants in securities class action lawsuit filed in the United States District Court for the Southern District of New York. This action, which is captioned In re Satyam Infoway Ltd. Initial Public Offering Securities Litigation, also names several of the underwriters involved in Sify s initial public offering of American Depositary Shares as defendants. This

class action is brought on behalf of a purported class of purchasers of Sify s ADSs from the time of Sify s Initial Public Offering (IPO) in October 1999 through December 2000. The central allegation in this action is that the underwriters in Sify s IPO solicited and received undisclosed commissions from, and entered into undisclosed arrangements with, certain investors who purchased Sify s ADSs in the IPO and the aftermarket. The complaint also alleges that Sify violated the United States Federal Securities laws by failing to disclose in the IPO prospectus that the underwriters had engaged in these allegedly undisclosed arrangements. More than 300 issuers have been named in similar lawsuits.

On April 2, 2009, the parties lodged with the Court a motion for preliminary approval of a proposed settlement between all parties, including the Company and its former officers and directors. The proposed settlement provides the plaintiffs with $586 million in recoveries from all defendants. Under the proposed settlement, the Issuer Defendants collectively would be responsible for $100 million, which would be paid by the Issuers insurers, on behalf of the Issuer Defendants and their officers and directors.

Accordingly, any direct financial impact of the proposed settlement is expected to be borne by the Sify s insurers. On June 12, 2009, the Federal District Court granted preliminary approval of the proposed settlement. On October 6, 2009, the District Court issued an order granting final approval of the settlement. Subsequent to the final approval of Settlement agreement by the District court, there were several notices of appeal filed. Most were filed by the same parties that objected to the settlement in front of the District Court. These appeals were consolidated into a single appeal and briefing schedule was held. On January 9, 2012 the class counsel and objectors counsel entered into a settlement agreement, which agreement includes an agreement to dismiss the above appeal. Thus the above Appeal has been dismissed with prejudice confirming the Settlement agreement entered before the District Court.

The Company believes, the maximum exposure under this settlement is approximately USD 338,983, an amount which its insurer will pay as per the Settlement agreement on behalf of the Company.

(b) Proceedings before Department of Telecommunications

(i) License fees

On October 12, 2009 (as later clarified by the DoT), the Department of Telecommunications (DOT) raised a demand on Sify Technologies for INR 14 million after correcting the arithmetical error in the Assessment letter.

On February 26, 2010 DOT raised a demand on Sify Communications (erstwhile subsidiary merged with Sify Technologies Limited) for INR 26 million.

The above demands were made by the DoT on the premise that all amounts of income (whether direct or indirect) including certain items like other income, interest on deposits, gain on foreign exchange fluctuation, profit on sale of assets & provision written back, that have got anything to do with telecom operations of the Company or arise in connection with the Telecom business of the Company, are to be considered as income for the purpose of calculation of the license fee. The company has replied suitably on the above demand notice.

The service providers had approached Telecom Disputes Settlement & Appellate Tribunal (TDSAT) on what all items of income are liable for calculation of license fee and what all items of income on which license fees are not liable to be paid. TDSAT by its order clarified on the above. The TDSAT order was challenged by DoT in Surpreme Court of India and the Supreme Court has set aside the TDSAT order. The service providers through their associations are contemplating for further appeal in Supreme Court by way of review petition. Sify believes that it inspite of Supreme Court order, the above demands are not tenable under law nor fit into the definition of Adjusted Gross Revenue as defined by DoT. The company believes it has adequate defences for these demands and the ultimate outcome of these actions may not have a material adverse effect.

(ii) In November 2009, the Company received a demand notice pertaining to the allocation of spectrum in the 3.3-3.4 GHz frequency, from DoT, demanding INR 345 million (US $ 7.05 million) towards spectrum charges payable from the date of issue of allocation letter for 170 Base Stations. As per the notice, in case no payment is received within 15 days from the date of issue of the notice, then it would be presumed that the Company is no longer interested for the frequency assignments in 3.3-3.4 GHz band.

Whilst the Company received allotment letter for Spectrum in *3.3 GHz band* (3303.5/3353.5 MHz) (Total 12 MHz) the Company had neither started any operations in this frequency band nor had applied for any Operating License from DOT/ Wireless Planning Commission (WPC). Sify believes that the obligation to make payment will arise only after obtaining the operating license from DOT/WPC. Sify also believes that it has adequate legal defences for these demands, as the Company has not yet obtained any operative license, hence such demand is not tenable Nevertheless, the Company has as a commitment to hold and use the spectrum in the above band has paid INR 11.56 million towards 40 Base Stations and has surrendered the remaining 130 Base Stations. The Company believes that the ultimate outcome of these actions will not have a material adverse effect.

c) The Group is party to additional legal actions arising in the ordinary course of business. Based on the available information, as at September 30, 2011, Group believes that it has adequate legal defences for these actions and that the ultimate outcome of these actions will not have a material adverse effect. However in the event of adverse judgement in all these cases, the maximum financial exposure would be Rs

12,668 (March 31, 2011: Rs 9,051)

21. Related party transactions

The following is a summary of significant transactions with related parties during the six months ended September 30, 2011:

Transactions	Six months ended September 30, 2011	Six months ended September 30, 2010
Consultancy services received	120	120
Share capital and share premium money received from promoter group	100,000	
Lease deposit paid (Refer note below)	2,558	2,558
Lease rentals paid (Refer note below)	1,536	1,024
Amount of outstanding balances		
Advance lease rentals and refundable deposits made (Refer note below)	2,558	285,383

Note

1. The Company has entered has into a lease agreement with Ms Radhika Vegesna, Daughter of Mr Anand Raju Vegesna, Executive Director of the company, to lease the premises owned by her for a period of three years effective June 1, 2010 on a rent of Rs.256 per month and payment of refundable security deposit of Rs.2,558. This arrangement will be automatically renewed for a further period of two blocks of three years with all the terms remaining unchanged.

22. Financial risk management

The Group s financial risk management objectives and policies are consistent with that disclosed in the consolidated financial statements as of and for the year ended March 31, 2011.

Credit risk: Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Group s trade receivables, treasury operations and other activities that are in the nature of leases.

Trade and other receivables

The Group s exposure to credit risk is influenced mainly by the individual characteristics of each customer. Management considers that the demographics of the Group s customer base, including the default risk of the industry and country in which customers operate, has less of an influence on credit risk. The group is not exposed to concentration of credit risk to any one single customer since the services are provided to and products are sold to customers who are spread over a vast spectrum. Credit risk is managed through credit approvals, establishing credit limits and continuously monitoring the credit worthiness of the customers to which the Company grants credit terms in the normal course of the business.

Cash and cash equivalents and other investments

In the area of treasury operations, the Group is presently exposed to counter-party risks relating to short term and medium term deposits placed with public-sector banks, and also to investments made in mutual funds.

Guarantees

The Group s policy is to provide financial guarantees only to subsidiaries and Companies within the Group.

The Chief Financial Officer is responsible for monitoring the counterparty credit risk, and has been vested with the authority to seek Board s approval to hedge such risks in case of need.

Liquidity risk: Liquidity risk is the risk that the Group will encounter difficulty in meeting the obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. The Group s approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions, without incurring unacceptable losses

or risking damage to the Group s reputation. Typically the Group ensures that it has sufficient cash on demand to meet expected operational expenses, servicing of financial obligations. In addition, the Group has concluded arrangements with well reputed Banks, and has unused lines of credit that could be drawn upon should there be a need. The Company is also in the process of infusing further capital from its promoter group for funding its requirements.

Market risk: Market risk is the risk of loss of future earnings or fair values or future cash flows that may result from a change in the price of a financial instrument. The value of a financial instrument may change as a result of changes in the interest rates, foreign exchange rates and other market changes that affect market risk sensitive instruments. Market risk is attributable to all market risk sensitive financial instruments including foreign currency receivables and payables. The Group is exposed to market risk primarily related to foreign exchange rate risk (currency risk), interest rate risk and the market value of its investments. Thus the Group s exposure to market risk is a function of investing and borrowing activities and revenue generating and operating activities in foreign currencies.

Currency risk: The Group s exposure in USD, Euro and other foreign currency denominated transactions gives rise to Exchange Rate fluctuation risk. Group s policy in this regard incorporates:

Forecasting inflows and outflows denominated in US$ for a twelve-month period

Estimating the net-exposure in foreign currency, in terms of timing and amount

Determining the extent to which exposure should be protected through one or more risk-mitigating instruments to maintain the permissible limits of uncovered exposures.

Carrying out a variance analysis between estimate and actual on an ongoing basis, and taking stop-loss action when the adverse movements breaches the 5% barrier of deviation, subject to review by Audit Committee.

23. Subsequent events

a) Insolvency petition filed by MF Global Overseas Limited, holding company of MF Global Sify Securities India Private Limited (Associate)

In the year 2000, REFCO - Sify Securities India Private Limited was formed as a Joint Venture company between REFCO Group Holdings Inc. and the Company. During November 2005, REFCO Group Holding Inc. sold its entire stake in REFCO Sify Securities India Private Limited to Man Financial Holdings Limited, the name which later changed into M F Global Overseas Limited (MFG). Consequent to this, MFG and the Company entered into a share holders Agreement dated 25th November 2005. MFG is a subsidiary of MF Global Holdings Limited, USA. Subsequent to the sale of shares to MFG, the name of the Joint Venture Company was changed into MF Global Sify Securities India Private Limited (Joint Venture Company).

As at September 30, 2011, the Company holds 29.85% in the Joint Venture Company and the remaining 70.15% was held by MFG. On October 31, 2011, M F Global Holding Limited, USA, sought bankruptcy protection through a chapter 11 filing in the U.S. Bankrptcy Court in New York. Consequent to this, MFG also filed for bankruptcy proceedings in the United Kingdom and 3 individual administrators from KPMG were appointed as Joint administrators for MFG which holds the shares in the Joint Venture Company.

The company was informed by the Joint Administrators that they are in the process of seeking bids for the stakes held by MFG in the Joint Venture Company. The Company believes that the auction process is in violation of the share holders agreement entered between MFG and the Company.

Hence, the Company has filed a petition under section 9 of the Arbitration and Conciliation Act 1996 in Bombay High Court, seeking for an interim relief restraining the Joint Administrators and MFG from proceeding with the proposed auction in respect of the sale of shares held by MFG in the Joint Venture Company in violation of share holders agreement dated November 25, 2005. The above petition came up for hearing on December 16, 2011 and has been adjourned to January 2012 for further proceedings. In parallel, the Company without prejudice to its legal rights is in discussion with the Joint Administrators of MFG for an early amicable settlement in this regard.

The company continues to evaluate various options available to ensure its interests in the associate is fully protected and are taking adequate legal support in India and US. MF Global is solvent and the Company believes that there is no material impact on the carrying value of the above investment in the consolidated financial statements of the Company.

Also refer note 7 to the consolidated financial statement for the quarter and six months ended September 30, 2011 elsewhere in this report.

b) Acquisition of shares of Hermit Projects private Limited

During the year ended March 31, 2009, Sify entered into an agreement for Sub Lease with VALS Developers Private Limited (VALS), who has entered into a Memorandum of Understanding (MoU) with the original owner of the property, to take on lease on long term basis the proposed building which was in the process of being constructed. The lease agreement, when final and executed, was expected to have an initial non-cancellable term of 5 years, with a further option for Sify to renew or cancel the lease for the incremental five year terms. In terms of this Agreement for Sub Lease, Sify has paid a security deposit of Rs.125,700 and advance rental of Rs.157,125 to VALS. As per the terms of the Sub Lease, the security deposit will be refunded at the end of lease term and the advance rental would be adjusted over a period of 15 months from the commencement of the lease.

On October 30, 2010, with the consent of VALS, the Board of Directors of the Company has approved the cancellation of the Agreement for Sub lease and has decided to acquire the building along with land directly through acquisition of Pace Info Com Park Private Limited (PACE), an unrelated third party, which is the owner of the land and building for total consideration of Rs.1,140,000. The above deposits would be adjusted against the consideration payable for acquiring the shares of PACE. To give effect to the above, the company has entered into an amendment Agreement with all concerned parties and VALS has assigned its rights and obligations to the company and the company paid Rs.400,000 as part consideration for the above purchase. On May 24, 2011 and on June 9, 2011, the company has paid a further sum of Rs.50,000 each as part consideration for the above purchase. On September 28, 2011, the company has paid a further sum of Rs.127,000 as per terms of MoU. As on date, the Company has paid an aggregate amount of Rs.909,800 towards the consideration. Also refer note 5 to the consolidated financial statement for the quarter and six months ended September 30, 2011.

Subsequently on November 28, 2011, the company acquired controlling interest by acquiring the entire shares of PACE through acquisition of shares of Hermit Projects Private Limited, its holding Company.

24. Group entities

The following are the entities that comprise the group as of September 30, 2011 and March 31, 2011

Particulars		**% of Ownership interest**	
Significant subsidiaries	**Country of incorporation**	**September 30, 2011**	**March 31, 2011**
Sify International Inc	US	100	100
Sify Software Limited (formerly known as Sify Networks Private Limited)	India	100	100
Sify Technologies Singapore Pte. Ltd	Singapore	100	100
Associates			
MF Global-Sify Securities India Private Limited	India	29.85	29.85

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion of the financial condition and results of operations of our Company should be read in conjunction with the Unaudited Condensed Consolidated Interim Financial Statements and the related condensed notes included elsewhere in this report and the audited financial statements and the related notes contained in our Annual Report on Form 20-F for the fiscal year ended March 31, 2011. This discussion contains forward-looking statements that involve risks and uncertainties. For additional information regarding these risks and uncertainties, please see the section in our Annual report captioned Risk Factors.

Overview

Sify is among the largest Internet, networking and e-Commerce services companies in India, offering end-to-end solutions with a comprehensive range of products delivered over a common Internet backbone infrastructure. This Internet backbone reaches more than 690 cities and towns in India. The operating segments are Enterprise services, Commercial and Consumer Services and Software services. A significant part of revenues is derived from Enterprise Services which includes Network Services and IT Services.

Revenue

We have been historically operating with three segments of business viz corporate network/data services, Internet access services (including Online portal services and content offerings) and others (e-Learning and Infrastructure Management services). The industry in which these segments compete has witnessed newer competitions, business models resulting in dynamic market changes. In order to leverage the versatility and the organizational capability, the Chief Operations Decision Maker (CODM) has evaluated options of integrating certain services to address customers across segments, achieve better marketability, flexibility and scale. Based on the management decision, certain changes to the business structure were made effective April 1, 2011. Consequently there were a change in operating segments as below:

Enterprise Service: Connectivity and voice services are offered as Network Services, while Data Center Hosting and Managed Services, along with System Integration, will comprise IT services. They will service both domestic and International clients from large corporate and mid-market customers.

Commercial and Consumer Service: The scope of the Consumer business is being expanded to include SOHOs and SMBs apart from the cybercafés, Portals and broadband-to-home services, offering network, IT services and applications through the Cloud.

Software Service: The application services and e-learning would from Software services. This business line will offer applications through the Cloud, primarily targeted at enterprise and international customers.

Enterprise Services

Enterprise services revenue primarily includes Network services and IT services. Network Services include revenues from connectivity services such as recurring revenues ,installation of the connectivity link, and, to a lesser extent, revenue from sale of hardware and software purchased from third party vendors and Voice Services viz., NLD (National Long Distance) and ILD (International Long Distance) services carrying voice traffic for carriers. Revenue is recognised based on the metered call units of voice traffic terminated on our network. Connectivity services include IP VPN services, Internet connectivity, and last mile connectivity (predominantly through wireless). IT Services includes web hosting revenues, primarily generated from co-location services and Managed services including infrastructure management services offered in overseas markets and System Integration services, security and consulting services. Sify, part of international offering, offers Network management services, Data center services, Security and information assurance services. Sify remotely manages the Information Technology infrastructure of global enterprises from India. The revenue from construction contracts are recognised based on the stage of completion of the contract with reference to the cost incurred till date to the total cost.

Commercial and consumer Retail Internet access services and Online Portal and content offerings

Internet access service revenues are generated from providing internet connectivity to our retail customers through public access and home access services which are primarily provided through broadband connectivity in arrangement with Cable Television Operators (CTOs). Our public access services with host of value added services are provided through franchised and Company-owned cybercafés, or e-ports . Additionally, we generate revenue by providing Internet Telephony services, allowing customers to make international telephone calls over the Internet. We also offer the premium broadband connection, branded Platinum to the SOHO market segment including domain names, e mail Ids, static IP.

Online portal services and content offerings revenues include advertising revenues from the various channels of our Internet portal, www.sify.com. We enter into contracts with customers to serve advertisements in the portal, and we are paid on the basis of impressions, click-through or leads.

Software services

Our software services offer application management services and e Learning services. As part of application management services we offer online assessment, document management services, web development and mailing solutions. e-learning services consists of structuring of contents, developing modules, delivery and training users in the modules developed. As these activities represents development of customised services, revenue is recognised based on percentage of completion method. Revenue in relation to time is measured as the agreed rate per unit of time multiplied by the units of time expended. The element of revenue related to materials is measured in accordance with the terms of the contract.

In Note 18 to the Unaudited Condensed Consolidated Interim Financial Statements included in this Report, we provide supplemental segment data, which provides separate revenue and operating income (loss) information for each of these business segments.

Expenses

Enterprise Services

This segment primarily comprises of Network and IT Services. Cost of goods sold and services rendered for the Network services consists of telecommunications costs necessary to provide services, and cost of goods in respect of hardware sold, cost of voice termination for VoIP , IUC charges for NLD (National Long Distance) and ILD (International Long Distance) services and other direct costs. Telecommunications costs include the costs of bandwidth procured from TELCOs and are required for access to the Internet, providing local telephone lines to our points of presence, the costs of using third-party networks pursuant to service agreements, leased line costs and costs towards spectrum fees payable to the Wireless Planning Commission or WPC for provision of spectrum to enable connectivity to be provided on the wireless mode for the last mile. Other costs include cost incurred towards our Annual Maintenance Contract (AMC), the cost of installation in connectivity business, In addition, 6% revenue share imposed by the Government of India as an annual license fee of the adjusted gross revenue generated from IP-VPN services and Voice services under the NLD/ILD license. Cost of goods sold and services rendered for the IT services includes cost of hardware and security services, the costs incurred in providing Hosting services, and cost of billable resources of managed services and other direct costs in relation to professional services rendered and cost of material procured for DC build services.

Commercial and Consumer Retail Internet access services and Online Portal and content offerings

Internet access services: Cost of goods sold and services rendered for the internet access services division consists primarily of recurring telecommunications costs necessary to provide service to subscribers through a cost transfer model between segments, the cost of goods sold and services rendered include commission paid to franchisees and cable television operators, voice termination charges for VoIP services. In addition, 6% revenue share imposed by the Government of India as an annual license fee of the adjusted gross revenue generated from VoIP Services.

Online portal and content offerings: Cost of goods sold and services rendered for the online portal services and content offerings includes the cost of procuring and managing content for the websites.

Software Services

Cost of revenues for the eLearning division includes the cost of direct associates and subject matter expert involved in the design and uploading of content for facilitating web-based learning. Cost of revenues for the Application management services includes cost of third party services for Document management services, share payable to the franchisees for online assessment , licences cost for mailing solution and cost of web development.

Selling, General and Administrative Expenses

Selling, general and administrative expenses consists of salaries and commissions for sales and marketing personnel, salaries and related costs for executives, financial and administrative personnel, sales, marketing, advertising and other brand building costs, travel costs, and occupancy and overhead costs.

Depreciation and amortization

We depreciate our tangible assets on a straight-line basis over the estimated useful life of assets, ranging from three to eight years and, in the case of buildings, 28 years. Intangibles excluding goodwill are amortised on a straight line basis over the estimated useful life of the assets, ranging from three to twenty years. Goodwill is not amortised and is tested for impairment annually.

Operating Results

Three months ended September 30, 2011 compared to three months ended September 30, 2010

Revenues. We recognized Rs.1,815 million ($37.10 million) in revenues for the quarter ended September 30, 2011, as compared to Rs.1717 million ($ 35.09 million) for the quarter ended September 30, 2010, representing an increase of Rs.98 million ($2.02 million), or 5.7%. This is primarily driven by an increase in revenues of Rs 108 million ($2.20 million) or 7.5% from our Enterprise Services and Rs 31 million ($0.64 million) or 21.53 % from Software services. The revenue growth has been impacted by Rs.41 million ($0.83 million) or 30.15 % decrease from our Commercial and Consumer services comprising of internet access services, online portals and content offerings.

Revenue from Enterprise Services has increased by Rs.108 million ($2.20 million), or 7.5%, from Rs.1436 million for the quarter ended September 30, 2010 to Rs 1,544 million ($31.56 million) for the quarter ended September 30, 2011 primarily due to increase of Rs.98 million ($2.0 million) in Network services and increase of Rs.10 million ($0.20 million) in IT services. Increase in Network services of Rs.98 million ($2.0 million) is due to (i) the increase of Rs.20 million ($0.41 million) from Connectivity services due to increase in number of links from 12984 in September 30, 2010 to 16,166 in September 30, 2011 (ii) the increase of Rs 76 million ($ 1.55 million) revenue from NLD (National Long Distance) and ILD (International Long Distance) and (iii) the increase of Rs.2 million ($0.04 million) in Hardware sales. The increase in NLD (National Long Distance) and ILD (International Long Distance) is on account of increase in volume by 97.8 million minutes contributing to an increase of Rs.69 million ($1.41 million) and increase in revenues from VoIP services by Rs.7 million ($0.14 million).

Increase in IT services of Rs.10 million ($0.21 million) is due to (i) the increase of Rs.45 million ($0.92 million) revenue from Hosting services on account of higher occupancy of datacenters from 57% in September 30, 2010 to 70% in September 30, 2011 (ii) the increase of Rs 34 million ($0.70 million) from international managed services. These increases are partially offset by a decrease of Rs 68 million ($1.40 million) in System Integration services. The reduction in System Integration is due to higher number of State Date centres in the previous period and also on account of lower hardware sales during the quarter ended September 30, 2011.

Revenue from Commercial and Consumer Services has decreased by Rs.41 million ($0.83 million) due to decrease in revenues of (i) Broadband services to the extent of Rs.20 million ($0.40) million or 26.5 %, due to loss of subscribers. (ii) e-Port service to the extent of Rs.23 million ($0.47 million) or 76.8 % due to drop in operational e-Ports and active subscribers and (iii) decrease of Rs.2 million ($0.04 million) or 81 % from voice revenue due to lower voice call minutes and is partially offset by an increase of Rs.3 million ($0.06 million) from SMB and SOHO services.

Revenue from Software Services has increased by Rs.31 million ($0.64 million) due to increase of Rs.46 million ($ 0.95 million) from Application management services. The increase in Application management services is primarily on account of (i) increase in revenues of Rs.30 million ($0.61 million) from online assessment (ii) increase in revenues of Rs.14 million ($0.28 million) from Document management services. The increase is partially offset by (i) decrease in e- Learning revenues by Rs.11 million ($0.22 million) and (ii) decrease in Hardware & software revenues by Rs.4 million ($ 0.09 million).

Other income : Other income was Rs.0.22 million ($0.004 million) for the quarter ended September 30, 2010, compared to Rs.20 million for the quarter ended September 30, 2011 representing a decrease of Rs.19.78 million ($0.40 million) or 99%. The other income during the quarter ended September 30, 2010 mainly was derived from duty credit entitlements under the Served from India Scheme (issued by the Government of India) in respect of the foreign exchange earnings from export of services. Such benefit was not available during the quarter ended September 30, 2011 as the scheme was withdrawn by the Government of India.

Cost of goods sold and services rendered. The cost of goods sold and services rendered was Rs.1,060 million ($ 21.66 million) for the quarter ended September 30, 2011 and Rs.1,054 million for the quarter ended September 30, 2010. Cost of goods sold for both the periods remained at the same level, with changes in few elements. These comprise of (i) a Rs.63 million ($1.29 million) increase in IUC costs pertaining to ILD services (ii) Rs. 23 million ($0.47 million) increase in Bandwidth costs due to increase in capacity (iii) a Rs.11 million ($0.22 million) increase in associate costs of technology department, (iv) Rs.9.1 million ($0.19 million) increase in direct resources costs in international business, (v) Rs.7 million ($0.14 million) towards cost of application management services, (vi) Rs.3 million ($0.06 million) increase in Revenue Share payable to TRAIand these increases have been offset by a decrease of (a) Rs.27 million ($0.55 million) in revenue share paid to franchisees and cable television operators due to drop in broadband & e-Port usage revenue (b) Rs.87 million ($1.78 million) in SI business due to change in mix and reduction in volume, and (c) Rs.10 million ($0.20 million) towards cost of application services.

Selling, general and administrative expenses. Selling, general and administrative expenses were Rs.619 million ($12.64 million) for the quarter ended September 30, 2011, compared to Rs.609 million for the quarter ended September 30, 2010, representing an increase of Rs.10 million ($0.21 million), or 1.74 %. This increase is mainly on account of the decrease of Rs. 13.82 million ($0.28 million) in personnel expenses, selling expenses, general and administrative costs and it is partially offset by an increase of operating expenses by Rs.29 million ($0.60 million . The increase in operating expenses is on account of costs associated with our new data center facility at Airoli and increased in network expenditure on account of expansion.

Depreciation and Amortisation expenses. Depreciation and amortization expenses were Rs.171 million($ 3.51 million) for the quarter ended September 30, 2011, compared to Rs.173 million for the quarter ended September 30, 2010, representing an increase of Rs.2 million $0.04 million, or 1.16%.

Net finance expense. The net finance expense was Rs 72 million ($ 1.48 million) for the quarter ended September 30, 2011, compared to Rs.58 million for the quarter ended September 30, 2010, representing an increase of Rs.14 million ($0.29 million), or 24.14%. The finance income was Rs.5 million ($0.10 million) for the quarter ended September 30, 2011, compared to Rs.14 million for the quarter ended September 30, 2010, representing a decrease of Rs.9 million ($0.18 million) due to decrease in fixed deposits. The finance expense was Rs. 77 million ($1.58 million) for the quarter ended September 30, 2011, compared to Rs.72 million for the quarter ended September 30, 2010, representing an increase of Rs.5 million ($ 0.10 million) or 6.49% due to hardening of interest rates on working capital loans.

Share of profit of investment in associate. The share of profit of investment in associate was Rs.19 million ($ 0.38 million) for the quarter ended September 30, 2011, compared to Rs.23 million for the quarter ended September 30, 2010, representing a decrease of Rs.4 million ($0.08 million) or 17.32%. Also refer to note 7 and note 23 to the notes to the unaudited condensed consolidated interim financial statements elsewhere in the report.

Six months period ended September 30, 2011 compared to Six months period ended September 30, 2010

Revenues. We recognized Rs.4,074 million ($83.27 million) as revenues for the six months ended September 30, 2011, as compared to Rs.3,445 million for the half year ended September 30, 2010, representing an increase of Rs.629 million ($12.86 million), or 18.26%. This is primarily driven by an increase in revenues of Rs 669 million ($13.67 million) or 23.2% from our Enterprise Services and Rs 45 million ($0.93 million) or 15.8 % from Software services. The revenue growth has been impacted by Rs 85 million ($1.74 million) or 30.2 % decrease from our Commercial and Consumer services comprising of internet access services, online portals and content offerings.

Revenue from Enterprise Services has increased by Rs 669 million ($13.67 million), or 23.25%, from Rs 2,878 million for six months ended September 30, 2010 to Rs 3,547 million ($72.60 million) for six months ended September 30, 2011 primarily due to increase of Rs 158 million ($3.23 million) in Network services and increase of Rs 511 million ($10.44 million) in IT services.

Increase in Network services of Rs 158 million ($3.23 million) is due to (i) increase of Rs.19 million ($0.38 million) from Connectivity services due to increase in No of links from 12984 in September 30, 2010 to 16,166 in September 30, 2011 (ii) increase of Rs 144 million ($ 2.94 million) revenue from NLD and ILD Services due to increase in volume by 29 million minutes contributing to an increase of Rs 131 million. and partially offset by decrease of Rs 4.12 million ($0.08 million) in Hardware sales.

Increase in IT services of Rs 511 million ($10.44 million) is due to (i) increase of Rs 486 million ($9.92 million) revenue from System integration services (ii) increase of Rs 90 million ($1.84 million) from hosting services on account of higher occupancy of datacenters from 57% in September 30, 2010 to 70% in September 30, 2011. The increase is partially offset by a decrease of Rs 65 million ($ 1.33 million) in managed services. The increase in System Integration services is primarily on account of large deal concluded during the six months ended September 30, 2011 amounting to Rs.50 million ($1.02 million) .

Revenue from Commercial and Consumer Services has decreased by Rs 85 million ($1.73 million) primarily due to decrease of (i) revenues from Broadband service to the extent of Rs 38 million ($0.77 million) or 25.1 %, due to loss of subscribers. (ii) revenues from e-Port service to the extent of Rs 47 million ($0.96 million) or 73% due to drop in operational e-Ports and active subscribers (iii) Rs 5 million ($0.09 million) or 81.8 % from voice revenue due to lower voice call minutes and is partially offset by an increase of Rs. 4 million ($0.08 million) from the SMB and SOHO services.

Revenue from Software Services has increased by Rs 45 million ($0.92 million) due to (i) Increase of Rs 67 million ($ 1.37 million) from Application management services. The increase in Application management services is primarily on account of (i) increase in revenues by Rs 43 million ($ 0.88 million) from online assessment (ii) increase in revenues by Rs 16 million ($ 0.33 million) from Document management services. The increase is partially offset by decrease of Rs 16 million ($0.33 million) in e Learning revenues.

Other income. Other income was Rs.2 million ($0.03 million) for six months ended September 30, 2011, compared to Rs.39 million for six months ended September 30, 2010, representing an decrease of Rs.37 million ($0.76 million), or 95 %. primarily on account of duty credit entitlement. The other income during the quarter ended September 30, 2011 mainly was derived from duty credit entitlements under the Served from India Scheme (issued by the Government of India) in respect of the foreign exchange earnings from export of services. Such benefit was not available during the six months ended September 30, 2011 as the scheme was withdrawn by Government of India.

Cost of goods sold and services rendered. The cost of goods sold and services rendered was Rs.2,617 million ($ 53.48 million) for six months ended September 30, 2011 compared to Rs.2,128 million for six months ended September 30, 2010, representing an increase of Rs.489 million ($10 million), or 2.30 %. This increase is due to (i) a Rs.312 million ($ 6.38 million) increase in System Integration Services primarily due to servicing a large one time deal. (ii) Rs.122 million ($2.50 million) increase in other direct costs on account of IUC costs pertaining to ILD services(iii) Increase in Band width costs by Rs.42 million ($0.86 million) on account of increase in capacity (iv) Rs.26 million ($.53 million) increase in Other direct costs (v) Rs.23 million ($0.47 million) in associate costs of technology department, (vi) Rs.14 million ($0.28 million) increase in direct cost of international business (vii) Increase of Rs.3 million ($.06 million) in Revenue Share payable to TRAI. These increases have been partly offset by a decrease of (a) Rs.55 million ($1.17 million) in the revenue share paid to franchisees and CTO operators due to reduction in usage revenue.

Selling, general and administrative expenses. Selling, general and administrative expenses were Rs.1,212 million ($ 24.76 million) for six months ended September 30, 2011, compared to Rs.1,240 million for six months ended September 30, 2010, representing a decrease of Rs.46.8 million ($0.96 million), This decrease is mainly on account of decrease in associate expenses, selling expenses, general and administrative costs. These decreases are partially offset by an increase of operating expenses of Rs. 67.02 million ($ 1.37 million).

Depreciation, Amortisation and impairment expenses. Depreciation, amortization and impairment expenses were Rs.342 million ($ 6.99 million) for six months ended September 30, 2011, compared to Rs.350 million for six months ended September 30, 2010, representing an increase of Rs.8 million ($0.16 million), or 2.28 %.

Net finance expense. The net finance expense was Rs. 138 million ($ 2.83 million) for six months ended September 30, 2011, compared to net finance expense of Rs.121 million for six months ended September 30, 2010, representing a increase of Rs. 17 million ($0.35 million), or 14.05%. The finance income was Rs.8 million ($0.15 million) for six months ended September 30, 2011, compared to Rs.21 million for six months ended September 30, 2010, representing a decrease of Rs.13 million ($0.27 million) due to closure of fixed deposits. The finance expense was Rs. 146 million ($2.98 million) for six months ended September 30, 2011, compared to Rs.141 million for the quarter ended September 30, 2010, representing an increase of Rs.5 million ($0.10 million).

Share of profit of investment in associate. The share of profit of investment in associate was Rs.34 million ($ 0.70 million) for six months ended September 30, 2011, compared to Rs.38 million for six months ended September 30, 2010, representing a decrease of Rs.4 million ($0.08 million), or 10.52%. Also refer to note 7 and note 23 to the notes to the unaudited condensed consolidated interim financial statements elsewhere in this report.

Liquidity and Capital Resources

The following table summarizes our statement of cash flows for the periods presented:

	Six months ended		
Particulars	**September 30, 2011**	**September 30, 2010**	**September 30, 2011 U.S Dollars**
Loss after tax	(198,636)	(315,768)	(4,060)
Other adjustments for non-cash items	478,024	501,907	9,767
Income taxes paid	23,639	(13,130)	483
Net decrease (increase) in working capital	(199,572)	111,344	(4,077)
Net cash from / (used in) operating activities	123,455	284,353	2,522
Net cash from / (used in) investing activities	(382,121)	(183,404)	(7,809)
Net cash from / (used in) financing activities	724,708	(316,146)	14,811
Effect of exchange rate changes on cash and cash equivalents	(3,091)	1,375	(63)
Net increase / (decrease) in cash and cash equivalents	**462,950**	**(213,822)**	**9,461**

As of September 30, 2011 our current assets exceeded current liabilities by Rs.519 million ($ 10.61 million). Based on the projected cash flow, including cash from operations, available lines of credit, and the capital infusion from our promoter group, we believe we will have sufficient resources to meet capital expenditure needs and working capital requirements over the course of the next 12 months.

We intend to continue to focus on the reduction of our cash burn. Based upon our present business and funding plans, we believe that our cash and cash equivalents were Rs.327 million ($ 6.69 million) as of September 30, 2011, including bank overdraft of Rs.221 million ($4.51 million).

Our principal sources of liquidity are cash flow that we generate from our operations and borrowings from banks. Our external sources of credit include facilities sanctioned to us by Indian banks. We have working capital facilities in the form of cash credit and overdraft facilities of Rs.1,000 million ($20.44 million) and the same has been utilized to the extent of Rs.429.95 million ($8.79 million) as on September 30, 2011. Further, we were provided non-funded limits of Rs.1,350 million ($27.59 million) (primarily in the form of bank guarantees and letters of credit) out of which Rs.64 million ($1.31 million) remained unutilized as of September 30, 2011. We believe that our cash and cash equivalents, short-term investments, working capital lines and the proceeds from private placement to our promoter group are sufficient to meet our present capital expenditure and working capital requirements for the next 12 months. As previously disclosed, the private placement, consummated in October 2010, will provide up to Rs.400 crores ($86 million) from the promoter group, which can be drawn down as needed by the Company. Of the above, the Company has cumulatively drawn Rs.2,000 million ($40.87 million) as of September 30, 2011. However, our ongoing working capital requirements are significantly affected by the profitability of our operations and we continue to periodically evaluate existing and new sources of liquidity and financing.

We are taking steps to improve the cash position to meet our currently known requirements at least over the next twelve months. In the light of the highly dynamic nature of our business, however, we cannot assure you that our capital requirements and sources will not change significantly in the future.

Cash balances held were Rs.548 million ($11.20 million) and Rs.744 million as of September 30, 2011 and September 30, 2010, respectively. These amounts include cash and cash equivalents and restricted cash.

Cash from operating activities for six months ended September 30, 2011 and 2010 was Rs.123 million ($2.52 million) and Rs.284 million respectively. This is primarily due to increase in trade and other receivables by Rs.566 million ($ 11.57 million) and Rs.251 million for the six months September 30, 2011 and 2010 due to large gestation projects and pending adjustment with payables, increase in other assets by Rs.57 million ($ 1.16 million) for the six months period ended September 30, 2011 due to payment of rental deposits for new landing station and decrease of Rs.10 million for the six months September 30, 2010, increase in inventories by Rs.6 million ($ 0.13 million) and Rs.4 million for the six months September 30, 2011 and 2010 respectively, increase in trade and other payables by Rs.341 million ($ 6.96 million) and Rs.283 million for the six months September 30, 2011 and 2010 respectively due to pending adjustment with receivables, increase in deferred revenues by Rs.80 million ($1.63 million) and Rs.62 million for the six months September 30, 2011 and 2010 due to increase order booking and increase in employee benefits by Rs.9 million ($ 0.19 million) and Rs.12 million for the six months September 30, 2011 and 2010 respectively due to increase in salary base for employees.

Cash used in investing activities for the six months ended September 30, 2011 and 2010 was Rs.382 million ($7.81 million) and Rs.183 million. These amounts were principally incurred for the establishment of a new data center, installation of new cable landing station and purchase of routers, modems, ports, servers and other capital equipment in connection with the expansion of our network of Rs.340 million ($ 6.96 million) and Rs.149 million for the six months September 30, 2011 and 2010. Expenditure on intangibles increased by Rs.47 million ($ 0.96 million) and Rs.72 million for the six months ended September 30, 2011 and 2010. The above cash outflows were partially off-set by finance income received amounting to Rs.5 million ($ 0.10 million) and Rs.36 million for the six months September 30, 2011 and 2010 respectively.

Cash used in financing activities for six months ended September 30, 2011 was Rs.725 million ($ 14.81 million) represented by share capital and share premium money received from promoter group amounting to Rs.1,000 million ($ 20.44 million), proceeds received from exercise of stock options by employees amounting to Rs.14 million ($ 0.28 million), repayment to banks to the extent of Rs.96 million ($1.96 million) and finance lease liabilities to the extent of Rs.35 million ($ 0.71 million) and payment of finance charges of Rs.158 million ($3.24 million). The cash from financing activities for the six months ended September 30, 2009 was Rs.316 million represented by repayment to banks to the extent of Rs.142 million, payment of finance lease liabilities to the extent of Rs.23 million and payment of finance charges of Rs.151 million.

Income Tax Matters

We have a substantial business and capital loss being carry forward for financial reporting purposes. Under Indian Tax law, business loss carry forwards from a particular year may be used to offset taxable income over the next eight years and unabsorbed depreciation for an infinite number of years. The statutory corporate income tax rate and the surcharge thereon are subject to change in line with the changes announced in the Union Budget each year. For fiscal year 2010, the corporate Income Tax rate is 30%, subject to a surcharge of 10% (if the Company makes taxable profits greater than Rs.10 million) and education cess of 3%, resulting in an effective tax rate of 30.9% for companies who have taxable profits less than Rs.10 million and 33.99% for companies who have taxable profits greater than Rs.10 million. For fiscal year 2011, the corporate income tax rate is 30%, subject to a surcharge of 7.5% (if the Company makes taxable profits greater than Rs.10 million) and education cess of 3%, resulting in an effective tax rate of 30.9% for companies who have taxable profits less than Rs.10 million and 33.22% for companies who have taxable profits greater than Rs.10 million. Further in India, companies are subject to a Minimum Alternate Tax (MAT) of 18% on the book profits of the Company. Certain changes in the income tax rates were introduced in the union budget 2011-12 of the Government of India. The key changes included the reduction of the surcharge to 5% and the increase of MAT to 18.5% of book profits. We cannot assure you that the current income tax rate will remain unchanged in the future. We also cannot assure you that the surcharge will be in effect for a limited period of time or that additional surcharges will not be levied by the Government of India. Currently, dividend income is exempt from tax for shareholders. Domestic companies are liable to pay dividend distribution tax at the rate of 15% in addition to applicable surcharge and cess.

Off-Balance Sheet Arrangement

We have not entered into any off balance sheet arrangement other than contractual obligations such as operating lease arrangements disclosed below as defined by SEC final rule 67 (FR-67) Disclosures in Management s Discussion and Analysis about off balance sheet arrangements and aggregate contractual obligations.

Contractual obligations

Set forth below are our contractual obligations as of September 30, 2011:

	Payments due by period (Rs 000s)				
Contractual obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Long term debt obligations	189,619		173,336	16,283	
Short term borrowings	381,718	381,718			
Finance lease obligations	183,767	72,889	100,634	10,244	
Non-cancellable operating lease obligations	1,833,032	108,701	224,116	247,590	1,252,625
Payments towards Europe India Gateway	49,364	49,364			
Purchase obligations	311,878	311,878			

Also refer Note a c below

Notes to the table above on Contractual obligations

a) Other liabilities amounting to Rs.173 million ($3.54 million) primarily comprise of deposits received from franchisees. For such amounts, the extent of the amount and the timing of payment / cash settlement are not readily estimable or determinable, at present. Accordingly, we did not include these under contractual obligations.

b) Standby letter of credit and guarantees has not been included in the above mentioned table of contractual obligations.

c) In addition to the above noted contractual obligations, in accordance with IAS 19 *Employee Benefits*, the total accrued liability for defined benefit plans recognised as of September 30, 2011, was Rs.49 million ($ 1 million) and disclosed under employee benefits .

Item 3. Quantitative and Qualitative Disclosures about Market Risk

General

Market risk is the risk of loss of future earnings, to fair values or to future cash flows that may result from a change in the price of a financial instrument. The value of a financial instrument may change as a result of changes in the interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributable to all market risk sensitive financial instruments including investments, foreign currency receivables, payables and debt. Our exposure to market risk is a function of our investment and borrowing activities and our revenue generating activities in foreign currency. The objective of market risk management is to avoid excessive exposure of our earnings and equity to loss.

Please see Note 39 to the financial statements included in our Annual Report on Form 20-F for the year ended March 31, 2011.

Risk Management Procedures

We manage market risk through a corporate treasury department, which evaluates and exercises independent control over the entire process of market risk management. Our corporate treasury department recommends risk management objectives and policies which are approved by senior management and our Audit Committee. The activities of this department include management of cash resources, implementing hedging strategies for foreign currency exposures, borrowing strategies, and ensuring compliance with market risk limits and policies on a daily basis.

Recent Accounting Pronouncements

A number of new standards, amendments to standards and interpretations are not yet effective for the period ended September 30, 2011, and have not been applied in preparing these consolidated financial statements:

IFRS 9 Financial Instruments: In November 2009, the International Accounting Standards Board issued IFRS 9, Financial Instruments: Recognition and Measurement, to reduce the complexity of the current rules on financial instruments as mandated in IAS 39. The effective date for IFRS 9 is annual periods beginning on or after January 1, 2013 with early adoption permitted. IFRS 9 has fewer classification and measurement categories as compared to IAS 39 and has eliminated the categories of held to maturity, available for sale and loans and receivables. Further it eliminates the rule-based requirement of segregating embedded derivatives and tainting rules pertaining to held to maturity investments. For an investment in an equity instrument which is not held for trading, IFRS 9 permits an irrevocable election, on initial recognition, on an individual share-by-share basis, to present all fair value changes from the investment in other comprehensive income. No amount recognized in other comprehensive income would ever be reclassified to profit or loss. IFRS 9 was further amended in October 2010, and such amendment introduced requirements on accounting for financial liabilities. This amendment addresses the issue of volatility in the profit or loss due to changes in the fair value of an entity s own debt. It requires the entity, which chooses to measure a liability at fair value, to present the portion of the fair value change attributable to the entity s own credit risk in the other comprehensive income. The company is required to adopt IFRS 9 by accounting year commencing April 1, 2013. The company is currently evaluating the requirements of IFRS 9, and has not yet determined the impact on the consolidated financial statements.

IFRS 10, Consolidated Financial Statements, IFRS 11, Joint Arrangements and IFRS 12, Disclosure of Interests in Other Entities:

In May 2011, the International Accounting Standards Board issued IFRS 10, IFRS 11 and IFRS 12. The effective date for IFRS 10, IFRS 11 and IFRS 12 is annual periods beginning on or after January 1, 2013 with early adoption permitted.

IFRS 10 Consolidated Financial Statements builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. IFRS 10 replaces the consolidation requirements in SIC-12 Consolidation of Special Purpose Entities and IAS 27 Consolidated and Separate Financial Statements. The standard provides additional guidance for determining of control in cases of ambiguity for instance in case of franchisor franchisee relationship, de facto agent, silos and potential voting rights.

IFRS 11 Joint Arrangements determines the nature of an arrangement by focusing on the rights and obligations of the arrangement, rather than its legal form. IFRS 11 replaces IAS 31 Interests in Joint Ventures and SIC-13 Jointly-controlled Entities-Non-monetary Contributions by Venturers. IFRS 11 addresses only forms of joint arrangements (joint operations and joint ventures) where there is joint control whereas IAS 31 had identified three forms of joint ventures, namely jointly controlled operations, jointly controlled assets and jointly controlled entities. The standard addresses inconsistencies in the reporting of joint arrangements by requiring a single method to account for interests in jointly controlled entities, which is the equity method.

IFRS 12 Disclosure of Interests in Other Entities is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles and other off balance sheet vehicles. One major requirement of IFRS 12 is that an entity needs to disclose the significant judgments and assumptions it has made in determining:

- whether it has control, joint control or significant influence over another entity; and

- the type of joint arrangement when the joint arrangement is structured through a separate vehicle.

IFRS 12 also expands the disclosure requirements for subsidiaries with non-controlling interest, joint arrangements and associates that are individually material. IFRS 12 introduces the term structured entity by replacing Special Purpose entities and requires enhanced disclosures by way of nature and extent of, and changes in, the risks associated with its interests in both its consolidated and unconsolidated structured entities.

The company is required to adopt IFRS 10, IFRS 11 and IFRS 12 effective April 1, 2013. The company is currently evaluating the requirements of IFRS 10, IFRS 11 and IFRS 12, and has not yet determined the impact on the consolidated financial statements.

- **IFRS 13 Fair Value Measurement:** In May 2011, the International Accounting Standards Board issued IFRS 13, Fair Value Measurement to provide specific guidance on fair value measurement and requires enhanced disclosures for all assets and liabilities measured at fair value, and not restricted to financial assets and liabilities. The standard introduces a precise definition of fair value and a consistent measure for fair valuation across assets and liabilities, with a few specified exceptions. The effective date for IFRS 13 is annual periods beginning on or after January 1, 2013 with early adoption permitted. The company is required to adopt IFRS 13 by accounting year commencing April 1, 2013 and is currently evaluating the requirements of IFRS 13, and has not yet determined the impact on the consolidated financial statements.

- **IAS 1 (Amended) Presentation of Financial Statements:** In June 2011, the International Accounting Standard Board published amendments to IAS 1 Presentation of Financial Statements. The amendments to IAS 1 Presentation of Financial Statements require companies preparing financial statements in accordance with IFRS to group items within other comprehensive income that may be reclassified to the profit or loss separately from those items which would not be recyclable in the profit or loss section of the income statement. It also requires the tax associated with items presented before tax to be shown separately for each of the two groups of other comprehensive income items (without changing the option to present items of other comprehensive income either before tax or net of tax).

The amendments also reaffirm existing requirements that items in other comprehensive income and profit or loss should be presented as either a single statement or two consecutive statements. This amendment is applicable to annual periods beginning on or after July 1, 2012, with early adoption permitted. The company is required to adopt IAS 1 (Amended) by accounting year commencing April 1, 2013. The company has evaluated the requirements of IAS 1 (Amended) and the company does not believe that the adoption of IAS 1 (Amended) will have a material effect on its consolidated financial statements.

- **IAS 19 (Amended) Employee Benefits:** In June 2011, International Accounting Standards Board issued IAS 19 (Amended), Employee Benefits. The effective date for adoption of IAS 19(Amended) is annual periods beginning on or after January 1, 2013, though early adoption is permitted.

IAS 19 (Amended) has eliminated an option to defer the recognition of gains and losses through re-measurements and requires such gain or loss to be recognized through other comprehensive income in the year of occurrence to reduce volatility. The amended standard requires immediate recognition of effects of any plan amendments. Further it also requires assets in profit or loss to be restricted to government bond yields or corporate bond yields, considered for valuation of Projected Benefit Obligation, irrespective of actual portfolio allocations. The actual return

from the portfolio in excess of or less than such yields is recognized through other comprehensive income.

These amendments enhance the disclosure requirements for defined benefit plans by requiring information about the characteristics of defined benefit plans and risks that entities are exposed to through participation in those plans.

The amendments need to be adopted retrospectively. The company is required to adopt IAS 19 (Amended) by accounting year commencing April 1, 2013. The company is currently evaluating the requirements of IAS 19 (Amended) and has not yet determined the impact on the consolidated financial statements.

Critical accounting policies

The accounting policies applied by the group in these Unaudited Condensed Consolidated Interim Financial Statements are the same as those applied by the Group in its Consolidated Financial Statements as at and for the year ended March 31, 2011.

Also refer to Note 3 in unaudited condensed consolidated interim financial statements included with this Report.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

As of September 30, 2011, our management, with the participation of our chief executive officer and chief financial officer, has carried out an evaluation of the effectiveness of our disclosure controls and procedures. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding our required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well conceived and operated, can only provide reasonable assurance that the objectives of the disclosure controls and procedures are met.

Based on their evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2011, our disclosure controls and procedures were effective to provide reasonable assurance that the information required to be disclosed in filings and submissions under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified by the SEC s rules and forms, and that material information related to us is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions about required disclosure.

Changes in internal control over financial reporting

During the quarter ended September 30, 2011, there was no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The company is subject to legal proceedings and claims, which have arisen in the ordinary course of its business. These legal actions, when ultimately concluded and determined, will not, in the opinion of management, have a material effect on the results of operations or the financial position of the Company.

See Note 20 of notes to Unaudited Condensed Consolidated Interim Financial Statements in Part I above and Note 36 of the financial statements included in our Annual Report on Form 20-F for the year ended March 31, 2011.

Item 1A. Risk Factors

For information regarding factors that could affect the Company s results of operations, financial condition and liquidity, see the risk factors discussion set forth in Item 1A of our Annual Report on Form 20-F for the fiscal year ended March 31, 2011 and the information under Forward-Looking Statements included in this Report. There have been no material changes to our Risk Factors from those disclosed in our Annual Report on Form 20-F for the fiscal year ended March 31, 2011.

Item 2. Unregistered Sale of Equity Securities and Use of Proceeds

None.

Items 3. Defaults upon Senior Securities

None.

Item 4. Mine safety Disclosure

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

10.1 Amendment to Subscription Agreement dated September 7, 2011, by and between Sify Technologies Limited and Ananda Raju Vegesna (incorporated by reference to the Report on Form 6-K filed on September 8, 2011)

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 21, 2012

SIFY TECHNOLOGIES LIMITED

By: /s/ MP Vijay Kumar
Name: MP Vijay Kumar
Title: Chief Financial Officer

-family:Times New Roman" SIZE="2"> $6,949 $6,749 $6,717 $27,414

Interest expense

2,107 2,175 2,278 2,524 9,084

Net interest income

4,892 4,774 4,471 4,193 18,330

Provision for loan losses

246 394 489 1,171 2,300

Net interest income after provision for loan losses

4,646 4,380 3,982 3,022 16,030

Noninterest income

1,565 1,376 1,409 1,227 5,577

Noninterest expense

4,740 4,591 5,109 4,263 18,703

Income before income taxes

1,471 1,165 282 (14) 2,904

Income tax expense

414 347 45 (51) 755

Net income

1,057 818 237 37 2,149

Net income per share, basic and diluted

837 598 17 (7) 1,445 $0.28 $0.20 $0.01 $0.00 $0.49 **2008** Fourth Third Second First Total

Interest and dividend income

$7,257 $7,652 $7,564 $8,440 $30,913

Interest expense

2,987 3,034 2,984 3,788 12,793

Net interest income

4,270 4,618 4,580 4,652 18,120

Provision for loan losses

1,255 385 84 270 1,994

Net interest income after provision for loan losses

3,015 4,233 4,496 4,382 16,126

Noninterest income

1,420 1,496 1,535 1,500 5,951

Noninterest expense

4,368 3,852 3,977 3,817 16,014

Income before income taxes

67 1,877 2,054 2,065 6,063

Income tax expense

(57) 593 654 650 1,840

Net income

124 1,284 1,400 1,415 4,223

Net income per share, basic and diluted

$0.04 $0.44 $0.48 $0.49 $1.45

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Item 8. Financial Statements and Supplementary Data

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To the Shareholders March 2011
First National Corporation
Strasburg, Virginia

MANAGEMENT S REPORT REGARDING THE EFFECTIVENESS OF INTERNAL CONTROLS

OVER FINANCIAL REPORTING

The management of First National Corporation (the Corporation) is responsible for the preparation, integrity and fair presentation of the financial statements included in the annual report as of December 31, 2010. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management s judgments and estimates concerning the effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining an effective internal control structure over financial reporting. The Corporation s internal control over financial reporting includes those policies and procedures that pertain to the Corporation s ability to record, process, summarize and report reliable financial data. The internal control system contains monitoring mechanisms, and appropriate actions are taken to correct identified deficiencies. Management believes that internal controls over financial reporting, which are subject to scrutiny by management and the Corporation s internal auditor, support the integrity and reliability of the financial statements. Management recognizes that there are inherent limitations in the effectiveness of any internal control system, including the possibility of human error and the circumvention or overriding of internal controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. In addition, because of changes in conditions and circumstances, the effectiveness of internal control over financial reporting may vary over time.

In order to insure that the Corporation s internal control structure over financial reporting is effective, management assessed these controls as they conformed to accounting principles generally accepted in the United States of America and related call report instructions as of December 31, 2010. This assessment was based on criteria for effective internal control over financial reporting as described in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management believes that the Corporation maintained effective internal controls over financial reporting as of December 31, 2010. Management s assessment did not determine any material weakness within the Corporation s internal control structure. The Corporation s annual report does not include an attestation report of the Corporation s registered public accounting firm, Yount, Hyde & Barbour. P.C. (YHB), regarding internal control over financial reporting. Management report was not subject to attestation by YHB pursuant to temporary rules of the Securities and Exchange Commission that permit the Corporation to provide only management s report in its annual report.

The 2010 end of year financial statements have been audited by the independent accounting firm of Yount, Hyde & Barbour, P.C. (YHB). Personnel from YHB were given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and Committees thereof.

Management believes that all representations made to the independent auditors were valid and appropriate. The resulting report from YHB accompanies the financial statements.

The Board of Directors of the Corporation, acting through its Audit and Compliance Committee (the Committee), is responsible for the oversight of the Corporation s accounting policies, financial reporting and internal control. The Audit and Compliance Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit and Compliance Committee is responsible for the appointment and compensation of the independent auditors and approves decisions regarding the appointment or removal of members of the internal audit function. The Committee meets periodically with management, the independent auditors, and the internal auditor to insure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Corporation in addition to reviewing the Corporation s financial reports. The independent auditors and the internal auditor have full and unlimited access to the Audit and Compliance Committee, with or without the presence of the management of the Corporation, to discuss the adequacy of internal control over financial reporting, and any other matters which they believe should be brought to the attention of the Audit and Compliance Committee.

/s/ Dennis A. Dysart
Dennis A. Dysart
Interim Chief Executive Officer

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors

First National Corporation

Strasburg, Virginia

We have audited the accompanying consolidated balance sheets of First National Corporation and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for the years ended December 31, 2010, 2009 and 2008. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First National Corporation and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years ended December 31, 2010, 2009 and 2008, in conformity with U.S. generally accepted accounting principles.

Winchester, Virginia
March 24, 2011

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FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

December 31, 2010 and 2009

(in thousands, except share and per share data)

	2010	2009
Assets		
Cash and due from banks	$ 5,048	$ 6,100
Interest-bearing deposits in banks	10,949	8,877
Federal funds sold	7,500	
Securities available for sale, at fair value	60,420	60,129
Restricted securities, at cost	3,153	3,426
Loans held for sale	271	210
Loans, net of allowance for loan losses, 2010, $16,036, 2009, $7,106	418,994	436,129
Other real estate owned, net of valuation allowance, 2010, $3,341, 2009, $994	3,961	6,261
Premises and equipment, net	20,302	21,148
Interest receivable	1,667	1,710
Other assets	12,364	8,684
Total assets	$ 544,629	$ 552,674
Liabilities & Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	$ 78,964	$ 81,101
Savings and interest-bearing demand deposits	178,685	146,056
Time deposits	205,851	236,729
Total deposits	$ 463,500	$ 463,886
Other borrowings	20,122	20,186
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued interest and other liabilities	3,230	4,516
Commitments and contingencies		
Total liabilities	$ 496,131	$ 497,867
Shareholders Equity		
Preferred stock, $1,000 liquidation preference; 14,595 shares issued and outstanding	$ 14,127	$ 13,998
Common stock, par value $1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2010, 2,948,901 shares, 2009, 2,931,721 shares	3,686	3,664
Surplus	1,582	1,418
Retained earnings	28,969	35,104
Unearned ESOP shares		(42)
Accumulated other comprehensive income, net	134	665
Total shareholders equity	$ 48,498	$ 54,807

Total liabilities and shareholders equity	$ 544,629	$ 552,674

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statement of Operations

Three Years Ended December 31, 2010

(in thousands, except per share data)

	2010	2009	2008
Interest and Dividend Income			
Interest and fees on loans	$ 24,874	$ 24,691	$ 28,136
Interest on federal funds sold	2	5	11
Interest on deposits in banks	15	1	34
Interest and dividends on securities available for sale:			
Taxable interest	1,722	2,092	2,051
Tax-exempt interest	541	576	545
Dividends	61	49	136
Total interest and dividend income	$ 27,215	$ 27,414	$ 30,913
Interest Expense			
Interest on deposits	$ 5,903	$ 7,753	$ 10,299
Interest on federal funds purchased	12	37	112
Interest on company obligated mandatorily redeemable capital securities	439	470	642
Interest on other borrowings	460	824	1,740
Total interest expense	$ 6,814	$ 9,084	$ 12,793
Net interest income	$ 20,401	$ 18,330	$ 18,120
Provision for loan losses	11,731	2,300	1,994
Net interest income after provision for loan losses	$ 8,670	$ 16,030	$ 16,126
Noninterest Income			
Service charges on deposit accounts	$ 2,618	$ 2,539	$ 2,878
ATM and check card fees	1,432	1,196	1,136
Trust and investment advisory fees	1,244	1,126	1,329
Fees for other customer services	327	333	361
Net gains (losses) on sale of securities available for sale	(7)	10	2
Net gains (losses) on sale of premises and equipment		9	(106)
Net (losses) on sale of other real estate owned	(19)		
Net gains on sale of loans	263	210	119
Other operating income	205	154	232
Total noninterest income	$ 6,063	$ 5,577	$ 5,951

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Operations

(Continued)

Three years ended December 31, 2010

(in thousands, except per share data)

	2010	2009	2008
Noninterest Expense			
Salaries and employee benefits	$ 9,080	$ 8,697	$ 8,485
Occupancy	1,389	1,348	1,175
Equipment	1,372	1,416	1,391
Marketing	503	532	510
Stationery and supplies	375	507	457
Legal and professional fees	802	880	696
ATM and check card fees	827	734	657
FDIC assessment	730	973	253
Provision for other real estate owned	2,640	994	
Bank franchise tax	426	331	363
Other operating expense	2,398	2,291	2,027
Total noninterest expense	$ 20,542	$ 18,703	$ 16,014
(Loss) income before income taxes	$ (5,809)	$ 2,904	$ 6,063
Income tax (benefit) provision	(2,206)	755	1,840
Net (loss) income	$ (3,603)	$ 2,149	$ 4,223
Effective dividend and accretion on preferred stock	887	704	
Net (loss) income available to common shareholders	$ (4,490)	$ 1,445	$ 4,223
(Loss) earnings per common share, basic and diluted	$ (1.53)	$ 0.49	$ 1.45

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

Three years ended December 31, 2010

(in thousands)

	2010	2009	2008
Cash Flows from Operating Activities			
Net income (loss)	$ (3,603)	$ 2,149	$ 4,223
Adjustments to reconcile net income (loss) to net cash and cash equivalents provided by operating activities:			
Depreciation and amortization	1,225	1,274	1,201
Origination of loans held for sale	(16,371)	(16,795)	(8,393)
Proceeds from sale of loans held for sale	16,573	16,795	8,782
Net gains on sales of loans	(263)	(210)	(119)
Provision for loan losses	11,731	2,300	1,994
Provision for other real estate owned	2,640	994	
Net (gains) losses on sale of securities available for sale	7	(10)	(2)
Net (gains) losses on sale of premises and equipment		(9)	106
Net losses on sale of other real estate owned	19		
Accretion of security discounts	(40)	(65)	(51)
Amortization of security premiums	370	302	78
Compensation expense for ESOP shares allocated	42	190	147
Deferred income tax benefit	(3,986)	(1,850)	(659)
Changes in assets and liabilities:			
Decrease in interest receivable	43	53	464
(Increase) decrease in other assets	435	(1,611)	(667)
Increase (decrease) in accrued expenses and other liabilities	(1,521)	788	(244)
Net cash provided by operating activities	$ 7,301	$ 4,295	$ 6,860
Cash Flows from Investing Activities			
Proceeds from sales of securities available for sale	$ 1,509	$	$
Proceeds from sale of Federal Home Loan Bank stock	273	2,070	4,793
Proceeds from maturities, calls, and principal payments of securities available for sale	12,716	15,269	10,938
Purchases of securities available for sale	(15,278)	(19,653)	(11,246)
Purchases of Federal Home Loan Bank stock		(2,049)	(4,943)
Increase in federal funds sold	(7,500)		
Purchase of premises and equipment	(379)	(1,116)	(3,421)
Proceeds from sale of premises and equipment		225	
Proceeds from sale of other real estate owned	2,506	187	
Net (increase) decrease in loans	2,539	4,756	(6,864)
Net cash used in investing activities	$ (3,614)	$ (311)	$ (10,743)

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Three years ended December 31, 2010

(in thousands)

	2010	2009	2008
Cash Flows from Financing Activities			
Net increase (decrease) in demand deposits and savings accounts	$ 30,492	$ 13,043	$ (42,036)
Net increase (decrease) in time deposits	(30,878)	3,350	44,387
Proceeds from other borrowings	23,602	46,000	131,500
Principal payments on other borrowings	(23,666)	(71,211)	(126,667)
Principal payments on company obligated mandatorily redeemable capital securities			(3,093)
Proceeds from issuance of preferred stock		13,900	
Cash dividends paid on common stock	(1,433)	(1,529)	(1,630)
Cash dividends paid on preferred stock	(758)	(509)	
Shares issued to leveraged ESOP	(26)	(85)	(44)
Decrease in federal funds purchased		(2,456)	(953)
Net cash provided by (used in) financing activities	$ (2,667)	$ 503	$ 1,464
Increase (decrease) in cash and cash equivalents	$ 1,020	$ 4,487	$ (2,419)
Cash and cash equivalents, beginning of year	14,977	10,490	12,909
Cash and cash equivalents, end of year	$ 15,997	$ 14,977	$ 10,490
Supplemental Disclosures of Cash Flow Information			
Cash payments for:			
Interest	$ 7,088	$ 9,381	$ 12,883
Income taxes	$ 3,671	$ 515	$ 3,019
Supplemental Disclosures of Noncash Transactions			
Unrealized gains (losses) on securities available for sale	$ (425)	$ 1,181	$ 302
Transfer from loans to other real estate owned	$ 2,865	$ 3,142	$ 3,923
Change in pension liability	$ 379	$ (1,101)	$ 1,306
Split dollar liability	$	$	$ 986
Issuance of common stock, dividend reinvestment plan	$ 212	$ 105	$

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

Three years ended December 31, 2010

(in thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2007	$	$ 3,653	$ 1,453	$ 33,311	$ (379)	$ (179)		$ 37,859
Comprehensive income:								
Net income				4,223			$ 4,223	4,223
Other comprehensive loss, net of tax:								
Unrealized holding gains arising during the period (net of tax, $103)							201	
Reclassification adjustment (net of tax, $1)							(1)	
Pension liability adjustment (net of tax, $444)							(862)	
Other comprehensive loss (net of tax, $342)						(662)	$ (662)	(662)
Total comprehensive income							$ 3,561	
Effect of recognition of split dollar postretirement benefits (net of tax, $335)				(651)				(651)
Effect of changing pension plan measurement date pursuant to accounting rule change				(57)				(57)
Shares acquired by leveraged ESOP			(44)		147			103
Cash dividends ($0.56 per share)				(1,630)				(1,630)
Balance, December 31, 2008	$	$ 3,653	$ 1,409	$ 35,196	$ (232)	$ (841)		$ 39,185

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2008	$	$ 3,653	$ 1,409	$ 35,196	$ (232)	$ (841)		$ 39,185
Comprehensive income:								
Net income				2,149			$ 2,149	2,149
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, $405)							786	
							(7)	

Reclassification adjustment (net of tax, $3)								
Pension liability adjustment (net of tax, $374)							727	
Other comprehensive income (net of tax, $776)						1,506	$ 1,506	1,506
Total comprehensive income							$ 3,655	
Shares acquired by leveraged ESOP			(85)		190			105
Cash dividends on common stock ($0.56 per share)				(1,634)				(1,634)
Issuance of 8,861 shares common stock, dividend reinvestment plan		11	94					105
Issuance of 13,900 shares of preferred stock	13,900							13,900
Cash dividends on preferred stock				(509)				(509)
Accretion on preferred stock discount	98			(98)				
Balance, December 31, 2009	$ 13,998	$ 3,664	$ 1,418	$ 35,104	$ (42)	$ 665		$ 54,807

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FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders Equity

(Continued)

Three years ended December 31, 2010

(in thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2009	$ 13,998	$ 3,664	$ 1,418	$ 35,104	$ (42)	$ 665		$ 54,807
Comprehensive loss:								
Net loss				(3,603)			$ (3,603)	(3,603)
Other comprehensive loss, net of tax:								
Unrealized holding losses arising during the period (net of tax, $146)							(286)	
Reclassification adjustment (net of tax, $2)							5	
Pension liability adjustment (net of tax, $129)							(250)	
Other comprehensive loss (net of tax, $273)						(531)	$ (531)	(531)
Total comprehensive loss							$ (4,134)	
Shares acquired by leveraged ESOP			(26)		42			16
Cash dividends on common stock ($0.56 per share)				(1,645)				(1,645)
Issuance of 17,180 shares common stock, dividend reinvestment plan		22	190					212
Cash dividends on preferred stock				(758)				(758)
Accretion on preferred stock discount	129			(129)				
Balance, December 31, 2010	$ 14,127	$ 3,686	$ 1,582	$ 28,969	$	$ 134		$ 48,498

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Notes to Consolidated Financial Statements

Note 1. Nature of Banking Activities and Significant Accounting Policies

First National Corporation (the Company) is the financial holding company of First Bank (the Bank), First National (VA) Statutory Trust I (Trust I), First National (VA) Statutory Trust II (Trust II) and First National (VA) Statutory Trust III (Trust III). The Trusts were formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. The Bank owns First Bank Financial Services, Inc., which invests in partnerships that provide title insurance and investment services. The Bank owns Shen-Valley Land Holdings, LLC which holds other real estate owned and future office sites. The Bank provides commercial and personal loans, residential mortgages, credit cards, a variety of deposit products and personal trust and investment services to its customers in the northern Shenandoah Valley region of Virginia.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to accepted practices within the banking industry.

Principles of Consolidation

The consolidated financial statements of First National Corporation include the accounts of all five companies. All material intercompany balances and transactions have been eliminated in consolidation, except for balances and transactions related to the Trusts. The subordinated debt of these Trusts is reflected as a liability of the Company.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, fair value, deferred tax assets and liabilities, and other real estate owned.

Significant Group Concentrations of Credit Risk

Most of the Company s activities are with customers located within the northern Shenandoah Valley region of Virginia. The types of lending that the Company engages in are included in Note 3. The Company has identified a concentration of credit risk in the hotel industry and mortgage loans on real estate. See Note 3 for further information on this concentration of credit risk. The Company does not have a significant concentration to any one customer.

Cash and Cash Equivalents

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

Securities

Investments in debt securities with readily determinable fair values are classified as either held to maturity, available for sale (AFS) or trading based on management s intent. Currently all of the Company s debt securities are classified as AFS. Equity investments in the FHLB, the Federal Reserve Bank of Richmond and Community Bankers Bank are separately classified as restricted securities and are carried at cost. AFS securities are carried at estimated fair value with the corresponding unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either the Company (1) intends to sell the security or (2) it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If, however, the Company intends to sell the security and it is not more-than-likely that it will be required to sell the security before recovery, the Company must determine what portion of

the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income.

For equity securities carried at cost as restricted securities, impairment is considered to be other-than-temporary based on the Company s ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income. The Company regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which costs exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the Company s intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or estimated fair value. The Company, through its banking subsidiary, requires a firm purchase commitment from a permanent investor before a loan can be closed, thus limiting interest rate risk. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

The Bank enters into commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans that are intended to be sold are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 60 days. The Bank protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Bank commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Bank is not exposed to losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Bank determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the value of the underlying asset while taking into consideration the probability that the rate lock commitments will close. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on the rate lock commitments.

Loans

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The bank segments its loan portfolio into real estate loans, commercial loans, and consumer loans. Real estate loans are further divided into the following classes: Construction; 1-4 family residential; and Other Real Estate Loans. Descriptions of the Company s loan classes are as follows:

Commercial Loans: Commercial loans are typically secured with non-real estate commercial property. The Company makes commercial loans primarily to businesses located within our market area.

Real Estate Loans Construction: The Company originates construction loans for the acquisition and development of land and construction of condominiums, townhomes, and one-to-four family residences.

Real Estate Loans 1-4 Family: This class of loans includes loans secured by one to four family homes. Typically, the Bank originates fixed rate mortgage loans with the intent to sell to correspondent lenders. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

Real Estate Loans Other: This loan class consists primarily of loans secured by various types of commercial real estate typically in the Bank s market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches.

Consumer Loans: Consumer loans include all loans made to individuals for consumer or personal purposes. They include new and used automobile loans, unsecured loans and lines of credit.

A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate throughout the northern Shenandoah Valley region of Virginia. The ability of the Bank s debtors to honor their contracts is subject to the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances less the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued and credited to income based on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and

recognized as an adjustment of the related loan yield using the interest method.

A loan s past due status is based on the contractual due date of the most delinquent payment due. Loans are generally placed on nonaccrual status when the collection of principal or interest is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Loans greater than 90 days past due may remain on accrual status if management determines it has adequate collateral to cover the principal and interest. For those loans that are carried on nonaccrual status, payments are first applied to principal

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outstanding. A loan may be returned to accrual status if the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms of the loan and there is reasonable assurance the borrower will continue to make payments as agreed. These policies are applied consistently across the loan portfolio.

All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Any unsecured loan that is over 120 days past due is charged-off in full. Any secured loan that is 120 days delinquent and is considered by management to be uncollectible is partially charged-off and carried at the fair value of the collateral less estimated selling costs. This charge-off policy applies to all loan segments.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Additionally, management s policy is to evaluate substandard and doubtful loans greater than $500 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, residential and certain small commercial loans that are less than $500 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below.

In situations where, for economic or legal reasons related to a borrower s financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower s payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on nonaccrual status at the time of the TDR, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above. There were $14.4 million and $5.6 million classified as TDRs as of December 31, 2010 and 2009, respectively.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. For further information about the Company s loans and the allowance for loan losses, see Notes 3 and 4.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance represents an amount that, in management s judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management s judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower s ability to repay and the value of the collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revisions as more information becomes available. The evaluation also considers the following risk characteristics of each loan portfolio:

Residential mortgage loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

Real estate construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may, at any point in time, be less than the principal amount of the loan; Construction loans also bear the risk that the general contractor, who may or may not by a loan customer, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.

Commercial real estate and commercial and industrial loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because repayment of these loans may be dependent upon the profitability and cash flows of the business or project. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.

Consumer loans carry risk associated with the continued credit-worthiness of the borrower and the value of the collateral (i.e., rapidly depreciating assets such as automobiles), or lack thereof. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

The allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as impaired, and is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. For collateral dependent loans, an updated appraisal will be ordered if a current one is not on file. Appraisals are performed by independent third-party appraisers with relevant industry experience. Adjustments to the appraised value may be made based on recent sales of like properties or general market conditions when appropriate.

The general component relates to loans that are not considered impaired. These unimpaired loans are segregated by loan type and allowance factors are assigned by management based on a one-year loss history, delinquencies, national and local economic trends, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan segment. The general component recognizes potential losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management s assessment of the above described factors and the relative weights given to each factor.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to forty years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less. Software is amortized over its estimated useful life ranging from three to seven years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at lower of cost or fair value less cost to sell at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from other real estate owned. The Company had $4.0 million in other real estate owned at December 31, 2010 and $6.3 million at December 31, 2009.

Transfers of Financial Assets

Transfers of financial assets, including loan participations, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

Income Taxes

Deferred income tax assets and liabilities are determined using the liability method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that

would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the statement of income.

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Trust and Asset Management Department

Securities and other property held by the Trust and Asset Management Department in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Earnings Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. There are no potential common shares that would have a dilutive effect. Shares not committed to be released under the Company s leveraged Employee Stock Ownership Plan (ESOP) are not considered to be outstanding. See Note 11 for further information on the Company s ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per share were 2,939,561, 2,921,129 and 2,913,011 for the years ended December 31, 2010, 2009 and 2008, respectively.

Advertising Costs

The Company follows the policy of charging the production costs of advertising to expense as incurred. Total advertising expense incurred for 2010, 2009 and 2008 was $398 thousand, $442 thousand and $371 thousand, respectively.

Reclassifications

Certain reclassifications have been made to prior period balances to conform to the current year presentation.

Recent Accounting Pronouncements

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140 , was adopted into Codification in December 2009 through the issuance of Accounting Standards Update (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor s continuing involvement, if any, in transferred financial assets. ASU 2009-16 was effective for transfers on or after January 1, 2010. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued new guidance relating to variable interest entities. The new guidance, which was issued as SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 was effective as of January 1, 2010. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, Accounting for Various Topics Technical Corrections to SEC Paragraphs. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In February 2010, the FASB issued ASU 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC s reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a company s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting

periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance rollforward and modification disclosures, will be required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

On September 15, 2010, the SEC issued Release No. 33-9142, Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers. This release issued a final rule adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (SOX), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act. SOX Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934. Release No. 33-9142 was effective September 21, 2010.

On September 17, 2010, the SEC issued Release No. 33-9144, Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management s Discussion and Analysis. This interpretive release is intended to improve discussion of liquidity and capital resources in Management s Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant. This release was issued in conjunction with a proposed rule, Short-Term Borrowings Disclosures, that would require public companies to disclose additional information to investors about their short-term borrowing arrangements. Release No. 33-9144 was effective on September 28, 2010.

In January 2011, the FASB issued ASU 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. The amendments in this ASU temporarily delay the effective date of the disclosures about troubled debt restructurings in ASU 2010-20 for public entities. The delay is intended to allow the FASB time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011. The Company is currently assessing the impact that ASU 2011-01 will have on its consolidated financial statements.

The SEC has issued Final Rule No. 33-9002, Interactive Data to Improve Financial Reporting , which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of states and political subdivisions, corporate equity securities and restricted securities. Restricted securities include required equity investments in certain correspondent banks which have no readily determinable market value. Amortized costs and fair values of securities available for sale at December 31, 2010 and 2009, were as follows:

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

2009
(in thousands)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	$ 42,654	$ 1,593	$ (32)	$ 44,215
Obligations of states and political subdivisions	15,551	326	(171)	15,706
Corporate equity securities	19	189		208
	$ 58,224	$ 2,108	$ (203)	$ 60,129

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At December 31, 2010 and 2009, investments in an unrealized loss position that are temporarily impaired were as follows:

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

	2009 (in thousands)					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	$ 2,101	$ (32)	$	$	$ 2,101	$ (32)
Obligations of states and political subdivisions	1,558	(17)	1,785	(154)	3,343	(171)
	$ 3,659	$ (49)	$ 1,785	$ (154)	$ 5,444	$ (203)

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

At December 31, 2010, there were seven U.S. agency and mortgage-backed securities and eight obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company s investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.9 years at December 31, 2010.

The amortized cost and fair value of securities available for sale at December 31, 2010 by contractual maturity are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties. Corporate equity securities are not included in the maturity categories in the following maturity summary because they do not have a stated maturity date.

	(in thousands)	
	Amortized Cost	Fair Value
Due within one year	$ 408	$ 409
Due after one year through five years	3,188	3,280
Due after five years through ten years	18,860	19,270
Due after ten years	36,461	37,266
Corporate equity securities	23	195
	$ 58,940	$ 60,420

Proceeds from sales and calls of securities available for sale during 2010, 2009 and 2008 were $4.4 million, $6.0 million and $4.8 million, respectively. Gross gains of $13 thousand, $10 thousand and $2 thousand were realized on those sales during 2010, 2009 and 2008, respectively. Gross losses of $20 thousand were realized on those sales during 2010.

Securities having a book value of $26.0 million and $34.9 million at December 31, 2010 and 2009 were pledged to secure other borrowings, public deposits and for other purposes required by law.

The Company s investment in FHLB stock totaled $2.3 million at December 31, 2010. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par

value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at December 31, 2010, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the AFS securities portfolio.

Note 3. Loans

Loans at December 31, 2010 and 2009 are summarized as follows:

	(in thousands) 2010	2009
Real estate loans:		
Construction	$ 52,591	55,057
Secured by 1-4 family residential	121,506	118,675
Other real estate loans	207,371	201,282
Commercial and industrial	40,683	54,445
Consumer loans	12,879	13,776
Total loans	$ 435,030	$ 443,235
Allowance for loan losses	16,036	7,106
Loans, net	$ 418,994	$ 436,129

Consumer loans included $231 thousand and $157 thousand of demand deposit overdrafts at December 31, 2010 and 2009, respectively.

The Company has a credit concentration in mortgage loans on real estate. These loans totaled $381.5 million, or 88% of total loans and $375.0 million, or 85% of total loans, at December 31, 2010 and 2009, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations is dependent upon local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled $41.6 million at December 31, 2010, representing 86% of total equity and 10% of total loans. At December 31, 2009, this concentration totaled $42.9 million representing 78% of total equity and 10% of total loans. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this identified risk during the years ended December 31, 2009 and 2008 and charged down $147 thousand related to these loans during the year ended December 31, 2010.

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

				(in thousands)			
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Nonaccrual loans	Total Past Due	Current	Total Loans
Real estate loans:							
Construction	$ 525	$	$	$ 5,780	$ 6,305	$ 46,286	$ 52,591
Secured by 1-4 family residential	2,549	178	315	628	3,670	117,836	121,506
Other real estate loans	10,033	2,662	283	4,407	17,385	189,986	207,371
Commercial and industrial	1,048	3			1,048	39,632	40,683
Consumer	152	10		2	164	12,715	12,879
Total	$ 14,307	$ 2,853	$ 598	$ 10,817	$ 28,575	$ 406,455	$ 435,030

Loans past due greater than ninety days and still accruing interest at December 31, 2009 and 2008 totaled $237 thousand and $3.4 million, respectively.

Credit Quality Indicators

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

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

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

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

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

The following table provides an analysis of the credit risk profile of each loan class as of December 31, 2010:

			(in thousands)		
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction	$ 21,212	$ 5,237	$ 21,471	$ 4,671	$ 52,591
Secured by 1-4 family residential	106,722	4,435	10,349		121,506
Other real estate loans	143,874	17,915	43,443	2,139	207,371
Commercial and industrial	34,619	4,033	2,031		40,683
Consumer	12,864	13	1	1	12,879
Total	$ 319,291	$ 31,633	$ 77,295	$ 6,811	$ 435,030

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the years ended December 31, 2010, 2009 and 2008 were as follows:

		(in thousands)	
	2010	**2009**	**2008**
Balance at beginning of year	$ 7,106	$ 5,650	$ 4,207
Provision charged to operating expense	11,731	2,300	1,994
Loan recoveries	261	298	253
Loan charge-offs	(3,062)	(1,142)	(804)
Balance at end of year	$ 16,036	$ 7,106	$ 5,650

The following table presents, as of December 31, 2010, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

			(in thousands)			
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer Loans	Total
Allowance for loan losses:						
Ending Balance	$ 858	$ 9,187	$ 4,050	$ 1,681	$ 260	$ 16,036
Ending Balance:						
Individually evaluated for impairment	36	5,020	3,006	536		8,597
Collectively evaluated for impairment	822	4,167	1,044	1,145	260	7,439
Loans:						
Ending Balance	40,683	207,371	52,591	121,506	12,879	435,030

Ending Balance:						
Individually evaluated for impairment	48	28,426	9,709	5,682		43,865
Collectively evaluated for impairment	40,635	178,945	42,882	115,824	12,879	391,165

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Impaired loans, which include TDR s of $14.4 million, and the related allowance at December 31, 2010 and 2009, were as follows:

	(in thousands)						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	$ 10,440	$ 1,217	$ 8,492	$ 9,709	$ 3,006	$ 2,920	$ 374
Secured by 1-4 family	5,701	595	5,087	5,682	536	795	222
Other real estate loans	29,480	7,904	20,522	28,426	5,020	18,432	1,345
Commercial and industrial	48		48	48	36	163	4
Consumer							
Total	$ 45,669	$ 9,716	$ 34,149	$ 43,865	$ 8,597	$ 22,310	$ 1,945

The Recorded Investment amounts in the table above represent the outstanding principal balance on each loan represented in the table. The Unpaid Principal Balance represents the outstanding principal balance on each loan represented in the table plus any amounts that have been charged off on each loan and/or payments that have been applied towards principal on nonaccrual loans.

The balance of impaired loans was $8.1 million, including TDR s of $5.6 million, at December 31, 2009, for which there were specific valuation allowances of $1.5 million. The average balance of impaired loans for 2009 was $11.2 million.

Non-accrual loans excluded from impaired loan disclosure amounted to $2 thousand, $196 thousand and $36 thousand at December 31, 2010, 2009 and 2008, respectively. If interest on these loans had been accrued, such income would have approximated $6 thousand and $2 thousand for 2009 and 2008, respectively. For 2010, there was no income that would have been accrued on these loans.

Note 5. Premises and Equipment

Premises and equipment are summarized as follows at December 31, 2010 and 2009:

	(in thousands)	
	2010	**2009**
Land	$ 4,664	$ 5,061
Buildings and leasehold improvements	16,031	15,680
Furniture and equipment	9,617	9,382
Construction in process	485	532
	$ 30,797	$ 30,655
Less accumulated depreciation	10,495	9,507
	$ 20,302	$ 21,148

Depreciation expense included in operating expenses for 2010, 2009 and 2008 was $1.2 million, $1.3 million and $1.2 million, respectively.

Note 6. Deposits

The aggregate amount of time deposits, in denominations of $100 thousand or more, was $114.1 million and $125.2 million at December 31, 2010 and 2009, respectively.

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2010 and 2009, brokered deposits totaled $35.6 million and $42.9 million, respectively, and were included in time deposits on the Company s financial statements.

At December 31, 2010, the scheduled maturities of time deposits were as follows:

	(in thousands)
2011	$ 129,352
2012	31,936
2013	20,426
2014	11,075
2015	13,062
	$ 205,851

Note 7. Other Borrowings

The Bank had unused lines of credit totaling $127.7 million and $124.8 million available with non-affiliated banks at December 31, 2010 and 2009, respectively. These amounts primarily consist of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta in which the Bank can borrow up to 19% of its assets.

At December 31, 2010 and 2009, the Bank had borrowings from the Federal Home Loan Bank system totaling $20.0 million for both periods, which mature through March 28, 2013. The interest rate on these borrowings ranged from 1.25% to 2.44% and the weighted average rate was 2.01% at December 31, 2010. The Bank had collateral pledged on these borrowings at December 31, 2010 including real estate loans totaling $64.1 million and Federal Home Loan Bank stock with a book value of $2.3 million.

At December 31, 2010, the Bank had a $122 thousand note payable, secured by a deed of trust, for land purchased to construct a banking office, which requires monthly payments of $2 thousand, and matures January 3, 2016. The fixed interest rate on this loan is 4.00%.

The contractual maturities of other borrowings at December 31, 2010 were as follows:

	(in thousands)
2011	$ 10,023
2012	5,023
2013	5,024
2014	25
2015	27
	$ 20,122

Note 8. Company Obligated Mandatorily Redeemable Capital Securities

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, $5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at December 31, 2010 was 2.90%. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions beginning June 17, 2009. The principal asset of Trust II is $5.2 million of the Company s junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, $4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a fixed rate of interest of 7.26% until July 31, 2011. The securities then have a LIBOR-indexed floating rate of interest. The securities have a mandatory redemption date of October 1, 2036, and are subject to varying call provisions beginning October 1, 2011. The principal asset of Trust III is $4.1 million of the Company s junior subordinated debt securities with maturities and interest rates comparable to

the trust preferred securities. The Trust s obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At December 31, 2010, the total amount of trust preferred securities issued by the Trusts was included in the Company s Tier 1 capital.

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Note 9. Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2007.

Net deferred tax assets consisted of the following components at December 31, 2010 and 2009:

	(in thousands)	
	2010	**2009**
Deferred Tax Assets		
Allowance for loan losses	$ 5,452	$ 2,416
Allowance for other real estate owned	1,136	338
Interest on non-accrual loans	194	186
Unfunded pension liability	434	305
Split dollar liability	363	335
Gain on other real estate owned	710	763
Other	124	78
	$ 8,413	$ 4,421
Deferred Tax Liabilities		
Depreciation	$ 713	$ 772
Prepaid pension	92	112
Securities available for sale	445	648
Discount accretion	9	10
Loan origination costs, net	124	123
Other		44
	$ 1,383	$ 1,709
Net deferred tax assets	$ 7,030	$ 2,712

The provision for income taxes for the years ended December 31, 2010, 2009 and 2008 consisted of the following:

		(in thousands)	
	2010	**2009**	**2008**
Current tax expense	$ 1,780	$ 2,605	$ 2,499
Deferred tax (benefit)	(3,986)	(1,850)	(659)
	$ (2,206)	$ 755	$ 1,840

The income tax provision (benefit) differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2010, 2009 and 2008, due to the following:

		(in thousands)	
	2010	**2009**	**2008**

Computed tax expense (benefit) at statutory federal rate	$ (1,975)	$ 988	$ 2,061
Decrease in income taxes resulting from:			
Tax-exempt interest and dividend income	(197)	(202)	(188)
Other	(34)	(31)	(33)
	$ (2,206)	$ 755	$ 1,840

Note 10. Funds Restrictions and Reserve Balance

Transfers of funds from the banking subsidiary to the parent company in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. The net loss available to common shareholders totaled $4.5 million for the year ended December 31, 2010 compared to common dividends paid to shareholders totaling $1.6 million during the same period. As a result, the Bank could not transfer funds to the Company without prior regulatory approval at December 31, 2010.

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The Bank must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final weekly reporting period in the years ended December 31, 2010 and 2009, the aggregate amounts of daily average required balances were approximately $1.1 million and $710 thousand, respectively.

Note 11. Benefit Plans

Pension Plan

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank s funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

In 2008, the Company adopted a change in accounting guidance for defined benefit pension and other postretirement plans. This guidance requires that defined benefit plan assets and obligations are to be measured as of the date of the employer s fiscal year-end. As a result of this adoption, the Company was required to change the measurement date for the pension plan assets and benefit obligations from October 1 to December 31 beginning in 2008. The following table provides a reconciliation of the changes in the plan benefit obligation and the fair value of assets for the periods ended December 31, 2010, 2009 and 2008.

		(in thousands)	
	2010	**2009**	**2008**
Change in Benefit Obligation			
Benefit obligation, beginning of year	$ 4,747	$ 4,522	$ 4,272
Service cost	307	305	377
Interest cost	284	271	333
Actuarial (gain) loss	565	(328)	(381)
Benefits paid	(315)	(23)	(79)
Benefit obligation, end of year	$ 5,588	$ 4,747	$ 4,522
Changes in Plan Assets			
Fair value of plan assets, beginning of year	$ 3,921	$ 2,851	$ 4,192
Actual return on plan assets	478	923	(1,262)
Employer contributions	200	170	
Benefits paid	(315)	(23)	(79)
Fair value of assets, end of year	$ 4,284	$ 3,921	$ 2,851
Funded Status, end of year	$ (1,303)	$ (826)	$ (1,671)
Amount Recognized in Other Liabilities	$ (1,303)	$ (826)	$ (1,671)
Amounts Recognized in Accumulated Other Comprehensive Loss, net of tax			
Net loss	$ 1,271	$ 893	$ 1,997
Prior service cost	6	9	12
Net obligation at transition		(4)	(10)
Deferred income tax benefit	(434)	(305)	(680)
Amount recognized	$ 843	$ 593	$ 1,319
Weighted Average Assumptions Used to Determine Benefit Obligation			

Discount rate used for disclosure	5.50%	6.00%	6.00%
Expected return on plan assets	8.00%	8.00%	8.50%
Rate of compensation increase	4.00%	4.00%	4.00%

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	(in thousands)		
	2010	**2009**	**2008**
Components of Net Periodic Benefit Cost			
Service cost	$ 307	$ 306	$ 302
Interest cost	284	271	266
Expected return on plan assets	(313)	(227)	(351)
Amortization of prior service cost	3	3	4
Amortization of net obligation at transition	(4)	(6)	(6)
Recognized net actuarial loss	21	79	13
Net periodic benefit cost	$ 298	$ 426	$ 228
Other Changes in Plan Assets and Benefit Obligations Recognized in Accumulated Other Comprehensive (Income) Loss			
Net (gain) loss	$ 378	$ (1,103)	$ 1,303
Amortization of prior service cost	(3)	(3)	(4)
Amortization of net obligation at transition	4	5	7
Total recognized in accumulated other comprehensive (income) loss	$ 379	$ (1,101)	$ 1,306
Total Recognized in Net Periodic Benefit Cost and Accumulated Other Comprehensive (Income) Loss	$ 677	$ (675)	$ 1,534
Adjustment to Retained Earnings due to Change in Measurement Date			
Service cost	N/A	N/A	$ 75
Interest cost	N/A	N/A	67
Expected return on plan assets	N/A	N/A	(88)
Amortization of prior service cost	N/A	N/A	1
Amortization of net obligation at transition	N/A	N/A	(1)
Recognized net actuarial loss	N/A	N/A	3
Net periodic benefit cost	N/A	N/A	$ 57
Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost			
Discount rate	6.00%	6.00%	6.25%
Expected return on plan assets	8.00%	8.00%	8.50%
Rate of compensation increase	4.00%	4.00%	4.00%

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience, which may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

The process used to select the discount rate assumption takes into account the benefit cash flow and the segmented yields on high-quality corporate bonds that would be available to provide for the payment of the benefit cash flow. A single effective discount rate, rounded to the nearest .25%, is then established that produces an equivalent discounted present value.

The pension plan s weighted-average asset allocations at the end of the plan year for 2010 and 2009, by asset category were as follows:

	2010	**2009**

Asset Category		
Mutual funds - fixed income	36%	38%
Mutual funds - equity	64%	61%
Other	0%	1%
Total	100%	100%

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 40% fixed income and 60% equities. The Investment Manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance for the implementation of the plan s investment strategy. The investment manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the trustee to administer the investments of the trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the trust.

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Following is a description of the valuation methodologies used for assets measured at fair value.

Fixed income and equity funds: Valued at the net asset value of shares held at year-end.

Cash and cash equivalents: Valued at cost which approximates fair value.

The following tables set forth by level, within the fair value hierarchy, the Company s pension plan assets at fair value as of December 31, 2010 and 2009:

	Fair Value Measurements at December 31, 2010 *(in thousands)*			
	Total	Level 1	Level 2	Level 3
Fixed income funds	$ 1,563	$ 1,563		
Equity funds	2,721	2,721		
Total	$ 4,284	$ 4,284	$	$

	Fair Value Measurements at December 31, 2009 *(in thousands)*			
	Total	Level 1	Level 2	Level 3
Cash and cash equivalents	$ 38	$ 38	$	$
Fixed income funds	1,494	1,494		
Equity funds	2,389	2,389		
Total	$ 3,921	$ 3,921	$	$

The Company made cash contributions of $240 thousand and $200 thousand for the 2010 and 2009 plan years, respectively, and expects to contribute $366 thousand for the 2011 plan year. The accumulated benefit obligation for the defined benefit pension plan was $3.8 million and $3.2 million at December 31, 2010 and 2009, respectively.

Estimated future benefit payments, which reflect expected future service, as appropriate, were as follows at December 31, 2010:

	(in thousands)
2011	$ 24
2012	24
2013	45
2014	54
2015	83
Years 2016-2020	1,236

401(k) Plan

The Company maintains a 401(k) plan for all eligible employees. Participating employees may elect to contribute up to the maximum percentage allowed by the Internal Revenue Service, as defined in the plan. The Company makes matching contributions up to the first three percent of an employee s compensation contributed to the Plan. The amount that the Company matches is contributed for the benefit of the respective employee to the employee stock ownership plan (ESOP). All employees who are age nineteen or older are eligible. Employee contributions vest immediately. Employer matching contributions vest after three plan service years with the Company. The Company has the discretion to make a profit sharing contribution to the plan each year based on overall performance, profitability, and other economic factors. For the years ended December 31, 2010, 2009 and 2008, expense attributable to the Plan amounted to $164 thousand, $103 thousand and $150 thousand, respectively.

Employee Stock Ownership Plan

On January 1, 2000, the Company established an employee stock ownership plan. The ESOP provides an opportunity for the Company to award shares of First National Corporation stock to employees at its discretion. Employees are eligible to participate in the ESOP effective immediately upon beginning service with the Company. Participants become 100% vested after three years of credited service. In addition to the 401(k) matching contributions made by the Company to the ESOP, the Board of Directors may make discretionary contributions, within certain limitations prescribed by federal tax regulations.

Until April 26, 2010, the ESOP operated as a leveraged ESOP. The ESOP s debt was incurred when the Company loaned the ESOP $570 thousand from the proceeds the Company received from its bank note payable. The ESOP shares initially were pledged as collateral for its debt. As the debt was repaid, shares were released from collateral and allocated to employees, based on the proportion of debt service paid in the year. The shares were deducted from shareholders equity as unearned ESOP shares in the accompanying balance sheets. As shares were released from collateral, the Company reported compensation expense equal to the current market price of the shares, and the shares became outstanding for EPS computations. Dividends on allocated ESOP shares were recorded as a reduction of retained earnings; dividends on unallocated ESOP shares were recorded as a reduction of debt and accrued interest. The ESOP s debt was repaid on April 26, 2010. Therefore, the ESOP is no longer operating as a leveraged ESOP.

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There was no compensation expense for the ESOP for the years ended December 31, 2010, 2009 and 2008.

Shares of the Company held by the ESOP at December 31, 2010, 2009 and 2008, are as follows:

	2010	2009	2008
Allocated shares	53,167	44,014	36,980
Unreleased shares		1,543	8,618
Total ESOP shares	53,167	45,557	45,598
Fair value of unreleased shares (in thousands)	$	$ 15	$ 140

Split Dollar Life Insurance Plan

On January 6, 1999, the Bank adopted a Director Split Dollar Life Insurance Plan. This Plan provides life insurance coverage to insurable outside directors of the Bank. The Bank owns the policies and is entitled to all values and proceeds. The Plan provides retirement benefits and the payment of benefits at the death of the insured director. The amount of benefits will be determined by the performance of the policies over the director s life.

Accounting guidance requires a company to recognize an obligation over the director s service period based upon the substantive agreement with the director such as the promise to maintain a life insurance policy or provide a death benefit postretirement. The Company adopted new accounting guidance on January 1, 2008 as a change in accounting principle through a cumulative-effect adjustment to retained earnings totaling $651 thousand. The related effect on net income recognized during the years ended December 31, 2010 and 2009 was expense of $36 thousand and a benefit of $42 thousand, respectively.

Note 12. Commitments and Unfunded Credits

The Company, through its banking subsidiary is a party to credit related financial instruments with risk not reflected in the consolidated financial statements in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Bank s exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2010 and 2009, the following financial instruments were outstanding whose contract amounts represent credit risk:

	(in thousands)	
	2010	2009
Commitments to extend credit and unfunded commitments under lines of credit	$ 53,494	$ 46,211
Stand-by letters of credit	6,917	6,002

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

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

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

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At December 31, 2010, the Bank had no locked-rate commitments to originate mortgage loans and had $271 thousand in loans held for sale. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

The Bank has cash accounts in other commercial banks. The amount on deposit at these banks at December 31, 2010 exceeded the insurance limits of the Federal Deposit Insurance Corporation by $28 thousand.

Note 13. Transactions with Related Parties

During the year, executive officers and directors (and companies controlled by them) were customers of and had transactions with the Company in the normal course of business. These transactions were made on substantially the same terms as those prevailing for other customers.

At December 31, 2010 and 2009, these loans totaled $11.7 million and $11.1 million, respectively. During 2010, total principal additions were $1.3 million and total principal payments were $660 thousand.

Deposits from related parties held by the Bank at December 31, 2010 and 2009 amounted to $4.2 million and $3.1 million, respectively.

Note 14. Lease Commitments

The Company was obligated under noncancelable leases for banking premises. Total rental expense for operating leases for 2010, 2009 and 2008 was $242 thousand, $227 thousand and $162 thousand, respectively. Minimum rental commitments under noncancelable leases with terms in excess of one year as of December 31, 2010 were as follows:

	(in thousands) **Operating Leases**
2011	$ 192
2012	181
2013	157
2014	101
2015	91
2016 and thereafter	85
Total minimum payments	$ 807

Note 15. Dividend Reinvestment Plan

The Company has in effect a Dividend Reinvestment Plan (DRIP) which provides an automatic conversion of dividends into common stock for enrolled shareholders. Stock was purchased on the open market on each dividend payable date during the first two quarters of 2009. On August 5, 2009, the Board of Directors of the Company passed a resolution authorizing the Company to issue common shares to the DRIP, beginning on the next dividend payment date, September 11, 2009. Common shares are purchased at a price which is based on the average closing prices of the shares as quoted on the Over-the-Counter Bulletin Board Market for the 10 business days immediately preceding the dividend payment date.

The Company issued 17,180 and 8,861 common shares to the DRIP during the years ended December 31, 2010 and 2009, respectively. The Company purchased 6,631 and 10,193 shares on the open market for the years ended December 31, 2009 and 2008, respectively.

Note 16. Fair Value Measurements

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurement and Disclosures topic of FASB ASC, the fair value of a financial instrument is the

price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

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

Level 1	Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
Level 2	Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
Level 3	Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires a significant management judgment or estimation.

A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following tables present the balances of financial assets measured at fair value on a recurring basis as of December 31, 2010 and 2009.

		Fair Value Measurements at December 31, 2010 Using *(in thousands)*		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				
U.S. agency and mortgage-backed securities	$ 46,924	$	$ 46,924	

Obligations of states and political subdivisions	13,301		13,301	
Corporate equity securities	195	195		
	$ 60,420	$ 195	$ 60,225	$

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Description	Balance as of December 31, 2009	Fair Value Measurements at December 31, 2009 Using (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale				
U.S. agency and mortgage-backed securities	$ 44,215	$	$ 44,215	$
Obligations of states and political subdivisions	15,706		15,706	
Corporate equity securities	208	208		
	$ 60,129	$ 208	$ 59,921	$

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the years ended December 31, 2010 and 2009.

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the net present value of expected future cash flows, the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business s financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Operations.

Other real estate owned

Loans are transferred to other real estate owned when the collateral securing them is foreclosed on or acquired through a deed in lieu of foreclosure. The measurement of loss associated with other real estate owned is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction

or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. Any fair value adjustments to other real estate owned are recorded in the period incurred and expensed against current earnings.

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The following tables summarize the Company s financial assets that were measured at fair value on a nonrecurring basis as of December 31, 2010 and 2009.

		Carrying Value at December 31, 2010 *(in thousands)*		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	$ 25,552	$	$ 17,584	$ 7,968

		Carrying Value at December 31, 2009 *(in thousands)*		
Description	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	$ 5,806	$	$ 5,771	$ 35

The following table summarizes the Company s nonfinancial assets that were measured at fair value on a nonrecurring basis as of December 31, 2010.

		Carrying Value at December 31, 2010 *(in thousands)*		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Other real estate owned	$ 3,961	$	$ 3,961	$

		Carrying Value at December 31, 2009 *(in thousands)*		
Description	Balance as of	Quoted Prices	Significant Other	Significant Unobservable

	December 31, 2009	in Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Inputs (Level 3)
Assets				
Other real estate owned	$ 6,261	$	$ 6,261	$

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

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Accounting guidance requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The methodologies for other financial assets and financial liabilities are discussed below:

Cash and Cash Equivalents and Federal Funds Sold

The carrying amounts of cash and short-term instruments approximate fair values.

Loans

For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for all other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposit Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Borrowings

The carrying amounts of federal funds purchased and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of all other borrowings are estimated using discounted cash flow analyses based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

Commitments and Unfunded Credits

The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2010 and 2009, fair value of loan commitments and standby letters of credit was immaterial.

The estimated fair values of the Company s financial instruments at December 31, 2010 and 2009 were as follows:

	(in thousands)			
	2010		**2009**	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and short-term investments	$ 23,497	$ 23,497	$ 14,977	$ 14,977
Securities available for sale	60,420	60,420	60,129	60,129
Loans, net	418,994	420,011	436,129	434,457
Loans held for sale	271	271	210	210
Accrued interest receivable	1,667	1,667	1,710	1,710

Financial Liabilities				
Deposits	$ 463,500	$ 433,300	$ 463,886	$ 421,115
Other borrowings	20,122	20,400	20,186	20,527
Company obligated mandatorily redeemable capital securities	9,279	9,279	9,279	9,784
Accrued interest payable	551	551	824	824

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The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company s financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company s overall interest rate risk.

Note 17. Regulatory Matters

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s and the Bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total (as defined in the regulations) and Tier 1 capital (as defined) to risk-weighted assets (as defined), and of Tier 1 capital to average assets. Management believes, as of December 31, 2010 and 2009, that the Company and the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2010, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank s category.

The Company s and the Bank s actual capital amounts and ratios are also presented in the following table.

			(amounts in thousands)		**Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions**	
	Actual		**Minimum Capital Requirement**			
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
December 31, 2010:						
Total Capital (to Risk Weighted Assets):						
Company	$ 63,163	14.18%	35,624	8.00%	N/A	N/A
Bank	$ 62,550	14.06%	35,584	8.00%	$ 44,480	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Company	$ 57,467	12.91%	17,812	4.00%	N/A	N/A
Bank	$ 56,861	12.78%	17,792	4.00%	$ 26,688	6.00%
Tier 1 Capital (to Average Assets):						
Company	$ 57,467	10.54%	21,810	4.00%	N/A	N/A
Bank	$ 56,861	10.40%	21,859	4.00%	$ 27,324	5.00%
December 31, 2009:						
Total Capital (to Risk Weighted Assets):						
Company	$ 68,892	14.96%	36,848	8.00%	N/A	N/A
Bank	$ 68,296	14.84%	36,815	8.00%	$ 46,019	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Company	$ 63,118	13.70%	18,424	4.00%	N/A	N/A
Bank	$ 62,527	13.59%	18,408	4.00%	$ 27,611	6.00%
Tier 1 Capital (to Average Assets):						

Company	$ 63,118	11.50%	21,961	4.00%	N/A	N/A
Bank	$ 62,527	11.37%	21,995	4.00%	$ 27,494	5.00%

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Note 18. Capital Purchase Program

On March 13, 2009, the Company entered into a Letter Agreement and Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement) with the Treasury Department, pursuant to which the Company sold (i) 13,900 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value $1.25 per share and liquidation preference $1,000 per share (the Preferred Stock) and (ii) a warrant (the Warrant) to purchase 695 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Warrant Preferred Stock), at an exercise price of $1.25 per share, for an aggregate purchase price of $13.9 million in cash. The Treasury immediately exercised the Warrant and, after net settlement, received 695 shares of the Company s Warrant Preferred Stock, which has a liquidation preference amount of $1,000 per share. Closing of the sale occurred on March 13, 2009 and increased Tier 1 and total capital by $13.9 million. The Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock pays cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock is amortized over a five year period using the constant effective yield method.

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Note 19. Parent Company Only Financial Statements

FIRST NATIONAL CORPORATION

(Parent Company Only)

Balance Sheets

December 31, 2010 and 2009

(in thousands)

	2010	2009
Assets		
Cash	$ 91	$ 110
Investment in subsidiaries, at cost, plus undistributed net income	57,058	63,413
Other assets	693	684
Total assets	$ 57,842	$ 64,207
Liabilities and Shareholders Equity		
Deferred income tax liability	$ 59	$ 64
Note payable		42
Company obligated mandatorily redeemable capital securities	9,279	9,279
Other liabilities	6	15
Total liabilities	$ 9,344	$ 9,400
Preferred stock	$ 14,127	$ 13,998
Common stock	3,686	3,664
Surplus	1,582	1,418
Retained earnings, which are substantially undistributed earnings of subsidiaries	28,969	35,104
Unearned ESOP shares		(42)
Accumulated other comprehensive income, net	134	665
Total shareholders equity	$ 48,498	$ 54,807
Total liabilities and shareholders equity	$ 57,842	$ 64,207

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FIRST NATIONAL CORPORATION

(Parent Company Only)

Statements of Operations

Three Years Ended December 31, 2010

(in thousands)

	2010	2009	2008
Income			
Dividends from subsidiary	$ 2,575	$ 2,575	$ 5,118
Other	11	(30)	3
	$ 2,586	$ 2,545	$ 5,121
Expense			
Interest expense	$ 439	$ 470	$ 642
Stationery and supplies	18	34	24
Legal and professional fees	20	75	59
Other	53	62	118
Total expense	$ 530	$ 641	$ 843
Income before allocated tax benefits and undistributed income of subsidiary	$ 2,056	$ 1,904	$ 4,278
Allocated income tax benefits	176	228	286
Income before equity in undistributed income of subsidiary	$ 2,232	$ 2,132	$ 4,564
Equity in (distributions in excess of) undistributed income of subsidiary	(5,835)	17	(341)
Net (loss) income	$ (3,603)	$ 2,149	$ 4,223
Effective dividend and accretion on preferred stock	887	704	
Net (loss) income available to common shareholders	$ (4,490)	$ 1,445	$ 4,223

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FIRST NATIONAL CORPORATION

(Parent Company Only)

Statements of Cash Flows

Three Years Ended December 31, 2010

(in thousands)

	2010	2009	2008
Cash Flows from Operating Activities			
Net income (loss)	$ (3,603)	$ 2,149	$ 4,223
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
(Undistributed) distributions in excess of earnings of subsidiaries	5,835	(17)	341
Compensation expense for ESOP shares allocated	42	190	147
(Increase) decrease in other assets	(23)	42	184
Increase (decrease) in other liabilities	(9)	7	(13)
Net cash provided by operating activities	$ 2,240	$ 2,371	$ 4,882
Cash Flows from Financing Activities			
Principal payments on company obligated mandatorily redeemable capital securities	$	$	$ (3,093)
Principal payments on other borrowings	(42)	(190)	(147)
Proceeds from issuance of preferred stock		13,900	
Distribution of capital to subsidiary		(13,900)	
Cash dividends paid on common stock	(1,433)	(1,529)	(1,630)
Cash dividends paid on preferred stock	(758)	(509)	
Shares issued to leveraged ESOP	(26)	(85)	(44)
Net cash used in financing activities	$ (2,259)	$ (2,313)	$ (4,914)
Increase (decrease) in cash and cash equivalents	$ (19)	$ 58	$ (32)
Cash and Cash Equivalents			
Beginning	110	52	84
Ending	$ 91	$ 110	$ 52

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

None.

Item 9A. Controls and Procedures

The Company s management has evaluated, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of disclosure controls and procedures as of December 31, 2010 pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2010, the disclosure controls and procedures are effective in ensuring that the information required to be disclosed in Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner and (2) accumulated and communicated to the Company s management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Refer to Item 8 of this report for the Management s Report on the Effectiveness of Internal Controls over Financial Reporting.

There were no changes in the Company s internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company s last fiscal quarter that materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information required by this Item is set forth under the headings Election of Directors Nominees, Executive Officers Who Are Not Directors, Section 16(a) Beneficial Ownership Reporting Compliance, Code of Conduct and Ethics, Committees and Director Selection Process in the Company s Proxy Statement for the 2011 Annual Meeting of Shareholders (the Proxy Statement), which information is incorporated herein by reference.

Item 11. Executive Compensation

Information required by this Item is set forth under the headings Executive Compensation and Director Compensation in the Proxy Statement, which information is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this Item is set forth under the heading Stock Ownership of Directors and Executive Officers and Stock Ownership of Certain Beneficial Owners in the Proxy Statement, which information is incorporated herein by reference.

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

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this Item is set forth under the headings Certain Relationships and Related Party Transactions and Director Independence in the Proxy Statement, which information is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

Information required by this Item is set forth under the headings Auditor Fees and Services and Policy for Approval of Audit and Permitted Non-Audit Services in the Proxy Statement, which information is incorporated herein by reference.

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PART IV

Item 15. Exhibits, Financial Statement Schedules

(a) (1) The response to this portion of Item 15 is included in Item 8 above.

(2) The response to this portion of Item 15 is included in Item 8 above.

(3) The following documents are attached hereto or incorporated herein by reference to Exhibits:

3.1 Amended and Restated Articles of Incorporation, as amended and restated on March 3, 2009 (incorporated herein by reference to Exhibit 3.1 to the Company s Form 10-K for the year ended December 31, 2008).

3.2 Articles and Amendment to the Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

3.3 Bylaws, as restated in electronic format only as of January 28, 2011 (incorporated herein by reference to Exhibit 3.2 to the Company s Current Report on Form 8-K filed with the SEC on January 28, 2011).

4.1 Specimen of Common Stock Certificate (incorporated herein by reference to Exhibit 1 to the Company s Form 10 filed with SEC on May 2, 1994).

4.2 Form of Certificate for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated herein by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

4.3 Form of Certificate for Fixed Rate Cumulative Perpetual Preferred Stock, Series B (incorporated herein by reference to Exhibit 4.3 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

10.3 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and Dennis A. Dysart (incorporated by reference to Exhibit 10.1 to the Company s Form 10-Q for the quarter ended September 30, 2007).

10.4 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and M. Shane Bell (incorporated by reference to Exhibit 10.2 to the Company s Form 10-Q for the quarter ended June 30, 2007).

10.5 Amended and Restated Employment Agreement, dated as of June 1, 2007, between the Company and Marshall J. Beverley, Jr. (incorporated by reference to Exhibit 10.3 to the Company s Form 10-Q for the quarter ended June 30, 2007).

10.6 Amendment to Employment Agreement between the Company and Dennis A. Dysart and M. Shane Bell (incorporated by reference to Exhibit 10.6 to the Company s Form 10-K for the year ended December 31, 2008).

10.7 Amendment to Employment Agreement between the Company and Marshall J. Beverley, Jr. (incorporated by reference to Exhibit 10.7 to the Company s Form 10-K for the year ended December 31, 2008).

10.8 Letter Agreement, dated as of March 13, 2009, by and between the Company and the United States Department of the Treasury (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

10.9 Side Letter Agreement, dated as of March 13, 2009, by and between the Company and the United States Department of the Treasury (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

10.10 Form of Waiver agreement between the Senior Executive Officers and the Company (incorporated herein by reference to Exhibit 10.3 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

10.11 Form of Consent agreement between the Senior Executive Officers and the Company (incorporated herein by reference to Exhibit 10.4 to the Company s Current Report on Form 8-K filed with the SEC on March 17, 2009).

14.1

Code of Conduct and Ethics (incorporated herein by reference to Exhibit 14.1 to the Company s Current Report on Form 8-K, filed on April 11, 2008).

21.1 Subsidiaries of the Company.

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23.1	Consent of Yount, Hyde & Barbour, P.C.
31.1	Certification of Chief Executive Officer, Section 302 Certification.
31.2	Certification of Chief Financial Officer, Section 302 Certification.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.
99.1	TARP Certification of Chief Executive Officer
99.2	TARP Certification of Chief Financial Officer

(b) Exhibits
See Item 15(a)(3) above.

(c) Financial Statement Schedules
See Item 15(a)(2) above.

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SIGNATURES

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

FIRST NATIONAL CORPORATION

By: /s/ Dennis A. Dysart

Interim Chief Executive Officer

(on behalf of the registrant and as

principal executive officer)

Date: March 23, 2011

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

/s/ Dennis A. Dysart	Date: March 23, 2011
Interim Chief Executive Officer	
(principal executive officer)	
/s/ M. Shane Bell	Date: March 23, 2011
Executive Vice President & Chief Financial Officer	
(principal financial officer and principal accounting officer)	
/s/ Douglas C. Arthur	Date: March 23, 2011
Chairman of the Board of Directors	
/s/ Byron A. Brill	Date: March 23, 2011
Vice Chairman of the Board of Directors	
/s/ Elizabeth H. Cottrell	Date: March 23, 2011
Director	
/s/ Dr. James A. Davis	Date: March 23, 2011
Director	
/s/ Christopher E. French	Date: March 23, 2011

Director

/s/ John K. Marlow	Date: March 23, 2011

Director

/s/ W. Allen Nicholls	Date: March 23, 2011

Director

/s/ Henry L. Shirkey	Date: March 23, 2011

Director

/s/ Gerald F. Smith, Jr.	Date: March 23, 2011

Director

/s/ James R. Wilkins, III	Date: March 23, 2011

Director

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EXHIBIT INDEX

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