NATIONAL BANKSHARES INC
Form 10-K
March 14, 2018

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[x] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2017

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____.

Commission File Number: 0-15204

NATIONAL BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

Virginia	54-1375874
(State of incorporation)	(I.R.S. Employer Identification No.)

101 Hubbard Street

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:	Securities registered Pursuant to Section 12(g) of the Act:
None	Common Stock, Par Value $1.25 per share

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definition of “accelerated filer, large accelerated filer, smaller reporting company and emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ] Accelerated filer [x] Non-accelerated filer [ ] Smaller reporting company [ ] Emerging growth company [ ]

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

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

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governance) on June 30, 2017 (the last business day of the most recently completed second fiscal quarter) was approximately $283,885,339. As of March 12, 2018, the registrant had 6,957,974 shares of voting common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference into the Part of the Form 10-K indicated.

Document	Part of Form 10-K into which incorporated
National Bankshares, Inc. 2017 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2018 Annual Meeting of Stockholders	Part III

Table of Contents

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-K

Index

Part I		**Page**
Item 1.	Business	3
Item 1A.	Risk Factors	10
Item 1B.	Unresolved Staff Comments	14
Item 2.	Properties	14
Item 3.	Legal Proceedings	15
Item 4.	Mine Safety Disclosures	15
Part II		
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	15
Item 6.	Selected Financial Data	17
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	44
Item 8.	Financial Statements and Supplementary Data	45
Item 9.	Changes In and Disagreements With Accountants on Accounting and Financial Disclosure	90
Item 9A.	Controls and Procedures	90
Item 9B.	Other Information	91
Part III		
Item 10.	Directors, Executive Officers and Corporate Governance	91
Item 11.	Executive Compensation	91

Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	91
Item 13.	Certain Relationships and Related Transactions, and Director Independence	91
Item 14.	Principal Accounting Fees and Services	91
Part IV		
Item 15.	Exhibits, Financial Statement Schedules	92
Item 16.	Summary Information	93
Signatures		94
Index of Exhibits		95

Table of Contents

Part I

$ in thousands, except per share data

Item 1. Business

History and Business

National Bankshares, Inc. (the "Company" or "NBI") is a financial holding company that was organized in 1986 under the laws of Virginia and is registered under the Bank Holding Company Act of 1956. It conducts most of its operations through its wholly-owned community bank subsidiary, the National Bank of Blacksburg ("NBB"). It also owns National Bankshares Financial Services, Inc. ("NBFS"), which does business as National Bankshares Insurance Services and National Bankshares Investment Services.

The National Bank of Blacksburg

The National Bank of Blacksburg, which does business as National Bank, was originally chartered in 1891 as the Bank of Blacksburg. Its state charter was converted to a national charter in 1922 and it became the National Bank of Blacksburg. In 2004, NBB purchased Community National Bank of Pulaski, Virginia. In May, 2006, Bank of Tazewell County, a Virginia bank which since 1996 was a wholly-owned subsidiary of NBI, was merged with and into NBB.

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, businesses, non-profits and local governments from its headquarters in Blacksburg, Virginia and its twenty-four branch offices throughout southwest Virginia and one loan production office in Roanoke Virginia. NBB has telephone and internet banking and it operates twenty-four automated teller machines in its service area.

The Bank's primary source of revenue stems from lending activities. The Bank focuses lending on small and mid-sized businesses and individuals. Loan types include commercial and agricultural, commercial real estate, construction for commercial and residential properties, residential real estate, home equity and various consumer loan products. The Bank has prudent lending policies to align its underwriting and portfolio management with its risk tolerance and income strategies. Underwriting and documentation requirements are tailored to the unique characteristics and inherent risks of each loan category.

The Bank's loan policy is updated and approved by the Board of Directors annually, and disseminated to lending and loan portfolio management personnel to ensure consistent lending practices. The policy communicates the Company's risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy,

documentation standards, requirements for collateral and loan-to-value limits, debt coverage and overall credit-worthiness, and guarantor support.

Of primary consideration is the repayment ability of the borrowers and (if secured) the collateral value in relation to the principal balance. Collateral lowers risk and may be used as a secondary source of repayment. The credit decision must be supported by documentation appropriate to the type of loan, including current financial information, income verification or cash flow analysis, tax returns, credit reports, collateral information, guarantor verification, title reports, appraisals (where appropriate), and other documents. A discussion of underwriting policies and procedures specific to the major loan products follows.

Commercial Loans. Commercial and agricultural loans primarily finance equipment acquisition, expansion, working capital, and other general business purposes. Because these loans have a higher degree of risk, the Bank generally obtains collateral such as inventories, accounts receivables or equipment, and personal guarantees from the borrowing entity's principal owners. The Bank's policy limits lending to 60% of the appraised value for inventory and equipment and up to 70% for accounts receivables less than 90 days old. Credit decisions are based upon an assessment of the financial capacity of the applicant, including the primary borrower's ability to repay within proposed terms, a risk assessment, financial strength of guarantors and adequacy of collateral. Credit agency reports of individual owners' credit history supplement the analysis.

Commercial Real Estate Loans. Commercial mortgages and construction loans are offered to investors, developers and builders primarily within the Bank's market area in southwest Virginia. These loans are secured by first mortgages on real estate. The loan amount is generally limited to 80% of the collateral value and is individually determined based on the property type, quality, location and financial strength of any guarantors. Commercial properties financed include retail centers, office space, apartments and industrial properties.

Underwriting decisions are based upon an analysis of the economic viability of the collateral and creditworthiness of the borrower. The Bank obtains appraisals from qualified certified independent appraisers to establish the value of collateral properties. The property's projected net cash flows compared to the debt service requirement (the "debt service coverage ratio" or "DSCR") is required to be 115% or greater and is computed after deduction for a vacancy factor and property expenses, as appropriate. Borrower cash flow may be supplemented by a personal guarantee from the principal(s) of the borrowe and guarantees from other parties. The Bank requires title insurance, fire, extended coverage casualty insurance and flood insurance, if appropriate, in order to protect the security interest in the underlying property. In addition, the Bank may employ stress testing techniques on higher balance loans to determine repayment ability in a changing rate environment before granting loan approval.

Public Sector and Industrial Development Loans. The Company provides both long and short term loans to municipalities and other governmental entities within its geographical footprint. Borrowers include general taxing authorities such as a city or county, industrial/economic development authorities or utility authorities. Repayment sources are derived from taxation, such as property taxes and sales taxes, or revenue from the project financed with the loan. The Company's underwriting considers local economic and population trends, reserves and liabilities, including pension liabilities.

Table of Contents

Construction Loans. Construction loans are underwritten against projected cash flows from rental income, business and/or personal income from an owner-occupant or the sale of the property to an end-user. Associated risks may be mitigated by requiring fixed-price construction contracts, performance and payment bonding, controlled disbursements and pre-sale contracts or pre-lease agreements.

Consumer Real Estate Loans. The Bank offers a variety of first mortgage and junior lien loans secured by primary residences to individuals within our markets. Credit decisions are primarily based on loan-to-value ("LTV") ratios, debt-to-income ("DTI") ratios, liquidity and net worth. Income and financial information is obtained from personal tax returns, personal financial statements and employment documentation. A maximum LTV ratio of 80% is generally required, although higher levels are permitted. The DTI ratio is limited to 43% of gross income.

Consumer real estate mortgages may have fixed interest rates for the entire term of the loan or variable interest rates subject to change after the first, third, or fifth year. Variable rates are based on the weekly average yield of United States Treasury Securities and are underwritten at fully-indexed rates. We do not offer certain high risk loan products such as interest-only consumer mortgage loans, hybrid loans, payment option ARMs, reverse mortgage loans, loans with initial teaser rates or any product with negative amortization. Hybrid loans are loans that start out as a fixed rate mortgage, but after a set number of years they automatically adjust to an adjustable rate mortgage. Payment option ARMs usually have adjustable rates, for which borrowers choose their monthly payment of either a full payment, interest only, or a minimum payment which may be lower than the payment required to reduce the balance of the loan in accordance with the originally underwritten amortization.

Home equity loans are secured primarily by second mortgages on residential property. The underwriting policy for home equity loans generally permits aggregate (the total of all liens secured by the collateral property) borrowing availability up to 80% of the appraised value of the collateral. We offer both fixed rate and variable rate home equity loans, with variable rate loans underwritten at fully-indexed rates. Decisions are primarily based on LTV ratios, DTI ratios, liquidity and credit history. We do not offer home equity loan products with reduced documentation.

Consumer Loans. Consumer loans include loans secured by automobiles, loans to consumers secured by other non-real estate collateral and loans to consumers that are unsecured. Automobile loans include loans secured by new or used automobiles. We originate automobile loans either on a direct basis or on an indirect basis through selected dealerships. We require borrowers to maintain collision insurance on automobiles securing consumer loans. Our procedures for underwriting consumer loans include an assessment of an applicant's overall financial capacity, including credit history and the ability to meet existing obligations and payments on the proposed loan. An applicant's creditworthiness is the primary consideration, and if the loan is secured by an automobile or other collateral, the underwriting process also includes a comparison of the value of the collateral security to the proposed loan amount.

Other Products and Services. Deposit products offered by the Bank include interest-bearing and non-interest bearing demand deposit accounts, money market deposit accounts, savings accounts, certificates of deposit, health savings accounts and individual retirement accounts. Deposit accounts are offered to both individuals and commercial businesses. Merchant credit card services and business and consumer debit and credit cards are available. NBB offers other miscellaneous services normally provided by commercial banks, such as letters of credit, night depository, safe deposit boxes, utility payment services and automatic funds transfer. NBB conducts a general trust business that has wealth management, trust and estate services for individual and business customers.

At December 31, 2017, NBB had total assets of $1,253,722 and total deposits of $1,059,806. NBB's net income for 2017 was $14,575, which produced a return on average assets of 1.18% and a return on average equity of 7.99%. Refer to Note 12 of the Notes to Consolidated Financial Statements for NBB's risk-based capital ratios.

National Bankshares Financial Services, Inc.

In 2001, National Bankshares Financial Services, Inc. was formed in Virginia as a wholly-owned subsidiary of NBI. NBFS offers non-deposit investment products and insurance products for sale to the public. NBFS works cooperatively with Infinex Investments, Inc. to provide investments and with Bankers Insurance, LLC for insurance products. NBFS does not significantly contribute to NBI’s net income.

Table of Contents

Operating Revenue

The following table displays components that contributed 15% or more of the Company's total operating revenue for the years ended December 31, 2017, 2016 and 2015.

Period	Class of Service	Percentage of Total Revenues	
December 31, 2017	Interest and Fees on Loans	57.96	%
	Interest on Investments	20.41	%
	Noninterest Income	20.10	%
December 31, 2016	Interest and Fees on Loans	57.73	%
	Interest on Investments	21.69	%
	Noninterest Income	19.53	%
December 31, 2015	Interest and Fees on Loans	58.10	%
	Interest on Investments	23.31	%
	Noninterest Income	18.10	%

Market Area

The Company's market area in southwest Virginia is made up of the counties of Montgomery, Roanoke, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It includes the independent cities of Roanoke, Radford and Galax, and the portions of Carroll and Grayson Counties that are adjacent to Galax. The Company also serves those portions of Mercer County and McDowell County, West Virginia that are contiguous with Tazewell County, Virginia. Although largely rural, the market area is home to two major universities, Virginia Tech and Radford University, and to three community colleges. Virginia Tech, located in Blacksburg, Virginia, is the area's largest employer and is the Commonwealth's second largest university. A second state supported university, Radford University, is located nearby. In recent years, Virginia Tech's Corporate Research Center has brought a number of technology-related companies to Montgomery County.

In addition to education, the market area has a diverse economic base with manufacturing, agriculture, tourism, healthcare, retail and service industries. Large manufacturing facilities in the region include Celanese Acetate, the largest employer in Giles County, and Volvo Heavy Trucks, the largest company in Pulaski County. Both of these firms have experienced cycles of hiring and layoffs within the past several years. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that has declined significantly in recent years and suffered from increased regulations. Montgomery County, Bluefield in Tazewell County and Abingdon in Washington County are regional retail centers and have facilities to provide basic health care for the region.

NBI's market area offers the advantages of a good quality of life, scenic beauty, moderate climate and historical and cultural attractions. The region has had some recent success attracting retirees, particularly from the Northeast and urban northern Virginia.

Because NBI's market area is economically diverse and includes large public employers, it has historically avoided the most extreme effects of past economic downturns. If the economic recovery wavers or reverses, it is likely that unemployment will rise and that other economic indicators will negatively impact the Company's trade area.

Competition

The banking and financial services industry in NBI's market area is highly competitive. The competitive business environment is a result of changes in regulation, changes in technology and product delivery systems and competition from other financial institutions as well as non-traditional financial services. NBB competes for loans and deposits with other commercial banks, credit unions, securities and brokerage companies, mortgage companies, insurance companies, retailers, automobile companies and other nonbank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than NBB. In order to compete, NBB relies upon a deep knowledge of its markets, a service-based business philosophy, personal relationships with customers, specialized services tailored to meet customers' needs and the convenience of office locations. In addition, the bank is generally competitive with other financial institutions in its market area with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts.

Cybersecurity

As a financial institution holding company, NBI is subject to cybersecurity risks and has suffered two cybersecurity incidents. To manage and mitigate cybersecurity risk, the Company limits certain transactions and interactions with customers. The Company does not offer online account openings or loan originations, limits the dollar amount of online banking transfers to other banks, does not permit customers to submit address changes or wire requests through online banking, requires a special vetting process for commercial customers who wish to originate ACH transfers, and limits certain functionalities of mobile banking. The Company also requires assurances from key vendors regarding their cybersecurity. While these measures reduce the likelihood and scope of the risk of cybersecurity breaches, in light of the evolving sophistication of system intruders, the risk to us of such breaches continues to exist. We maintain insurance for these risks but insurance policies are subject to exceptions, exclusions and terms whose applications have not been widely interpreted in litigation. Accordingly, insurance can provide less than complete protection against the losses that result from cybersecurity breaches and pursuing recovery from insurers can result in significant expense. In addition, some risks such as reputational damage and loss of customer goodwill, which can result from cybersecurity breaches cannot be insured against.

Table of Contents

Organization and Employment

NBI, NBB and NBFS are organized in a holding company/subsidiary structure. Functions that serve both subsidiaries, including audit, compliance, loan review and human resources, are at the holding company level, and fees are charged to the respective subsidiary for those services. In 2018, NBI employees will be transferred to NBB and fees will be charged to NBI for services performed by NBB.

At December 31, 2017, NBI employed 17 full time employees, NBB had 211 full time equivalent employees and NBFS had 4 full time employees.

Regulation, Supervision and Government Policy

NBI and NBB are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like NBI and NBB are at a disadvantage to other competitors who are not as highly regulated, and NBI and NBB's costs of doing business are accordingly higher. Legislative efforts to prevent a repeat of the 2008 financial crisis culminated in the Dodd-Frank Wall Street Reform Act of 2010. This legislation, together with existing and planned regulations, dramatically increased the regulatory burden on commercial banks. The burden falls disproportionately on community banks like NBB, which must devote a higher proportion of their human and other resources to compliance than do their larger competitors. The financial crisis has also heightened the examination focus by banking regulators, particularly on real estate-related assets and commercial loans. While the potential for additional laws and regulations that will impact the Company is reduced in the current environment, heightened examination standards with regard to asset quality remain a risk. The following is a brief summary of certain laws, rules and regulations that affect NBI and NBB.

National Bankshares, Inc.

NBI is a bank holding company qualified as a financial holding company under the Federal Bank Holding Company Act ("BHCA"), which is administered by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). NBI is required to file an annual report with the Federal Reserve and may be required to furnish additional information pursuant to the BHCA. The Federal Reserve is authorized to examine NBI and its subsidiaries. With some limited exceptions, the BHCA requires a bank holding company to obtain prior approval from the Federal Reserve before acquiring or merging with a bank or before acquiring more than 5% of the voting shares of a bank unless it already controls a majority of shares.

The Bank Holding Company Act. Under the BHCA, a bank holding company is generally prohibited from engaging in nonbanking activities unless the Federal Reserve has found those activities to be incidental to banking. Bank holding companies also may not acquire more than 5% of the voting shares of any company engaged in nonbanking activities. Amendments to the BHCA that were included in the Gramm-Leach-Bliley Act of 1999 (see below) permitted any bank holding company with bank subsidiaries that are well-capitalized, well-managed and which have a satisfactory or better rating under the Community Reinvestment Act (see below) to file an election with the Federal Reserve to become a financial holding company. A financial holding company may engage in any activity that is (i) financial in nature (ii) incidental to a financial activity or (iii) complementary to a financial activity. Financial activities include insurance underwriting, insurance agency activities, securities dealing and underwriting and providing financial, investment or economic advising services. NBI is a financial holding company that currently engages in insurance agency activities and providing financial, investment or economic advising services.

The Virginia Banking Act. The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission (the "Commission"). NBI is required to report to the Commission with respect to financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries and must approve the acquisition of ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act ("GLBA") permits significant combinations among different sectors of the financial services industry, allows for expansion of financial service activities by bank holding companies and offers financial privacy protections to consumers. GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. GLBA permits affiliations between banks and securities firms in the same holding company structure, and it permits financial holding companies to directly engage in a broad range of securities and merchant banking activities.

Table of Contents

The Sarbanes-Oxley Act. The Sarbanes-Oxley Act ("SOX") protect investors by improving the accuracy and reliability of corporate disclosures. It impacts all companies with securities registered under the Securities Exchange Act of 1934, including NBI. SOX creates increased responsibility for chief executive officers and chief financial officers with respect to the content of filings with the Securities and Exchange Commission. Section 404 of SOX and related Securities and Exchange Commission rules focused increased scrutiny by internal and external auditors on NBI's systems of internal controls over financial reporting, which is designed to ensure that those internal controls are effective in both design and operation. SOX sets out enhanced requirements for audit committees, including independence and expertise, and it includes stronger requirements for auditor independence and limits the types of non-audit services that auditors can provide. Finally, SOX contains additional and increased civil and criminal penalties for violations of securities laws.

Capital and Related Requirements. NBI is subject to risk-based capital regulations of the Federal Reserve. The regulations require a minimum ratio of certain capital measures. In addition, the Company is required to maintain a "capital conservation buffer" in excess of the minimum ratio requirements. The implementation period for the capital conservation buffer began in 2016 and will be fully phased in on January 1, 2019. The following table presents the required minimum ratios and minimum ratios with the capital conservation buffer for 2017, as well as the final minimum ratios with the capital conservation buffer when fully phased in:

Regulatory Capital Ratios	**Minimum Ratio**		**Minimum Ratio With Capital Conservation Buffer as of December 31, 2017**		**Minimum Ratio With Capital Conservation Buffer beginning January 1, 2019**	
Common Equity Tier 1 Capital to Risk Weighted Assets	4.50	%	5.75	%	7.00	%
Tier 1 Capital to Risk Weighted Assets	6.00	%	7.25	%	8.50	%
Total Capital to Risk Weighted Assets	8.00	%	9.25	%	10.50	%
Leverage Ratio	4.00	%	4.00	%	4.00	%

Risk-weighted assets are assets on the balance sheet as well as certain off-balance sheet items, such as standby letters of credit, to which weights between 0% and 1250% are applied, according to the risk of the asset type. Common Equity Tier 1 Capital ("CET1") is capital according to the balance sheet, adjusted for goodwill and intangible assets and other prescribed adjustments, as well as accumulated other comprehensive income if the Company elects to exclude. Tier 1 Capital is CET1 adjusted for additional capital deductions. Total Capital is Tier 1 Capital increased for the allowance for loan losses and adjusted for other items. The leverage ratio is the ratio of Tier 1 capital to total average assets, less goodwill and intangibles and certain deferred tax assets.

NBI is expected to be a source of capital strength for its subsidiary bank, and regulators can undertake a number of enforcement actions against NBI if its subsidiary bank becomes undercapitalized. NBI's bank subsidiary is well capitalized and fully in compliance with capital guidelines. Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for financial institutions could subject NBB or the Company to a variety

of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits and other restrictions on its business. Failure to maintain excess reserves for the capital conservation buffer would limit the ability to make capital distributions and pay discretionary bonuses to executives. As described above, significant additional restrictions can be imposed on NBB if it would fail to meet applicable capital requirements.

Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was signed into law on July 21, 2010. Its wide ranging provisions affect all federal financial regulatory agencies and nearly every aspect of the American financial services industry. The Dodd-Frank Act created an independent Consumer Financial Protection Bureau ("CFPB") which has the ability to write rules for consumer protections governing all financial institutions. All consumer protection responsibility formerly handled by other banking regulators was consolidated in the CFPB. It oversees the enforcement of all federal laws intended to ensure fair access to credit. For smaller financial institutions such as NBI and NBB, the CFPB coordinates its examination activities through their primary regulators.

The Dodd-Frank Act contains provisions designed to reform mortgage lending, which includes the requirement of additional disclosures for consumer mortgages, and the CFPB implemented many mortgage lending regulations to carry out its mandate. Additionally, in response to the Dodd-Frank Act, the Federal Reserve issued rules in 2011 which had the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation.

Although the Dodd-Frank Act provisions themselves are extensive and have required the Company and the Bank to deploy resources to comply with them, the ultimate impact on the Company of this massive legislation remains unknown. Several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, have yet to issue final regulations implementing major portions of the legislation, and this process is ongoing. In addition, the new Administration in Washington, D.C. may reform or rescind various provisions of the Dodd-Frank Act.

Source of Strength. Federal Reserve policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, the Company is expected to commit resources to support NBB, including at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Table of Contents

The National Bank of Blacksburg

NBB is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency ("the OCC"). NBB's deposits are insured by the Federal Deposit Insurance Corporation ("the FDIC") up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of NBB's operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. NBB is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs. The OCC requires NBB to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for NBB and other banks.

The Community Reinvestment Act. NBB is subject to the provisions of the Community Reinvestment Act ("CRA"), which imposes an affirmative obligation on financial institutions to meet the credit needs of the communities they serve, including low and moderate income neighborhoods. The OCC monitors NBB's compliance with the CRA and assigns public ratings based upon the bank's performance in meeting stated assessment goals. Unsatisfactory CRA ratings can result in restrictions on bank operations or expansion. NBB received a "satisfactory" rating in its last CRA examination by the OCC.

The Gramm-Leach-Bliley Act. In addition to other consumer privacy provisions, the Gramm-Leach-Bliley Act ("GLBA") restricts the use by financial institutions of customers' nonpublic personal information. At the inception of the customer relationship and annually thereafter, NBB is required to provide its customers with information regarding its policies and procedures with respect to handling of customers' nonpublic personal information. GLBA generally prohibits a financial institution from providing a customer's nonpublic personal information to unaffiliated third parties without prior notice and approval by the customer.

The USA Patriot Act. The USA Patriot Act ("Patriot Act") facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on NBB to establish and maintain anti-money laundering policies and procedures, including a customer identification program. The Bank must screen all customers against government lists of known or suspected terrorists. There is additional regulatory oversight to insure compliance with the Patriot Act.

Consumer Laws and Regulations. There are a number of laws and regulations that regulate banks' consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Electronic Funds Transfer Act, the Fair Debt Collections Practices Act, the Home Mortgage Disclosure Act, the

Service Members Civil Relief Act, laws governing flood insurance, federal and state laws prohibiting unfair and deceptive business practices, foreclosure laws and various regulations that implement some or all of the foregoing. NBB is required to comply with these laws and regulations in its dealings with customers. In addition, the CFPB has adopted and may continue to refine rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations.

Deposit Insurance. NBB has deposits that are insured by the FDIC. The FDIC maintains a Deposit Insurance Fund ("DIF") that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. The FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. Beginning April 1, 2011, an institution's assessment base became consolidated total assets less its average tangible equity as defined by the FDIC. The FDIC has authority to impose (and has imposed during the recent financial crisis) special measures to boost the deposit insurance fund such as prepayments of assessments and additional special assessments.

After giving primary regulators an opportunity to first take action, the FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution's deposit insurance. NBB has no knowledge of any matter that would threaten its FDIC insurance coverage.

Capital Requirements. The same capital requirements that are discussed above with relation to NBI are applied to NBB by the OCC. The OCC guidelines provide that banks experiencing internal growth or making acquisitions are expected to maintain strong capital positions well above minimum levels, without reliance on intangible assets. In addition, implementation of the BASEL III requirements could increase required capital minimums as well as compliance costs due to their complexity.

Table of Contents

Limits on Dividend Payments. A significant portion of NBI's income is derived from dividends paid by NBB. As a national bank, NBB may not pay dividends from its capital, and it may not pay dividends if the bank would become undercapitalized, as defined by regulation, after paying the dividend. Without prior OCC approval, NBB's dividend payments in any calendar year are restricted to the bank's retained net income for that year, as that term is defined by the laws and regulations, combined with retained net income from the preceding two years, less any required transfer to surplus.

The OCC and FDIC have authority to limit dividends paid by NBB if the payments are determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the bank's capital base could be deemed to be an unsafe and unsound banking practice.

Branching. As a national bank, NBB is required to comply with the state branch banking laws of Virginia, the state in which the bank is located. NBB must also have the prior approval of OCC to establish a branch or acquire an existing banking operation. Under Virginia law, NBB may open branch offices or acquire existing banks or bank branches anywhere in the state. Virginia law also permits banks domiciled in the state to establish a branch or to acquire an existing bank or branch in another state. The Dodd-Frank Act permits the OCC to approve applications by national banks like NBB to establish *de novo* branches in any state in which a bank located in that state is permitted to establish a branch.

Ability-to-Repay and Qualified Mortgage Rule. Pursuant to the Dodd-Frank Act, the CFPB amended Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) create a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance. The Company is predominantly an originator of compliant qualified mortgages.

Monetary Policy

The monetary and interest rate policies of the Federal Reserve, as well as general economic conditions, affect the business and earnings of NBI. NBB and other banks are particularly sensitive to interest rate fluctuations. The spread

between the interest paid on deposits and that which is charged on loans is the most important component of the bank's earnings. In addition, interest earned on investments held by NBI and NBB has a significant effect on earnings. U.S. fiscal policy, including deficits requiring increased governmental borrowing also can affect interest rates. As conditions change in the national and international economy and in the money markets, the Federal Reserve's actions, particularly with regard to interest rates, and the effects of fiscal policies can impact loan demand, deposit levels and earnings at NBB. It is not possible to accurately predict the effects on NBI of economic and interest rate changes.

Other Legislative and Regulatory Concerns

Particularly because of uncertain economic conditions and the current political environment, federal and state laws and regulations are regularly proposed that could affect the regulation of financial institutions. New, revised or rescinded regulations could add to the regulatory burden on banks and other financial service providers and increase the costs of compliance, or they could change the products that can be offered and the manner in which financial institutions do business. We cannot foresee how regulation of financial institutions may change in the future and how those changes might affect NBI.

Company Website

NBI maintains a website at www.nationalbankshares.com. The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission. The Company's proxy materials for the 2018 annual meeting of stockholders are also posted on a separate website at www.nationalbanksharesproxy.com.

Table of Contents

Item 1A. Risk Factors

If economic trends reverse or recession returns, our credit risk will increase and there could be greater loan losses.

A reversal in economic trends or return to a recession is likely to result in a higher rate of business closures and increased job losses in the region in which we do business. In addition, reduced State funding for the public colleges and universities that are large employers in our market area could have an adverse effect on employment levels and on the area's economy. These factors would increase the likelihood that more of our customers would become delinquent or default on their loans. A higher level of loan defaults could result in higher loan losses, which could adversely affect our performance.

A reversal in economic trends, return to recession, or change in interest rates could increase the risk of losses in our investment portfolio.

The Company holds both corporate and municipal bonds in its investment portfolio. A reversal in economic recovery or return to recession could increase the actual or perceived risk of default by both corporate and government issuers and, in either case, could adversely affect the value of these investments. In addition, the value of these investments could be affected by a change in interest rates and related factors, including the pricing of securities.

The condition of the local real estate market could negatively affect our business.

Substantially all of the Company's real property collateral is located in its market area. If there is a decline in real estate values, especially in the Company's market area, the collateral for loans would deteriorate and provide significantly less security.

Focus on lending to small to mid-sized community-based businesses may increase its credit risk.

Most of the Company's commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company's results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle since becoming borrowers of the Bank. The deterioration of the borrowers' businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company's financial condition and results of operations.

Market interest rates, while rising, remain historically low. When market interest rates rise further, our net interest income can be negatively affected in the short term.

The direction and speed of interest rate changes affect our net interest margin and net interest income. In the short term, rising interest rates may negatively affect our net interest income if our interest-bearing liabilities (generally deposits) reprice sooner than our interest-earning assets (generally loans).

The allowance for loan losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, an allowance for loan losses is maintained to provide for loan losses. The allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect operating results. The allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating, and other outside forces and conditions, including changes in interest rates, all of which are beyond the Company's control; and these losses may exceed current estimates. Federal regulatory agencies, as an integral part of their examination process, review the Company's loans and allowance for loan losses. While management believes that the allowance for loan losses is adequate to cover current losses, it cannot make assurances that it will not further increase the allowance for loan losses or that regulators will not require it to increase this allowance. Either of these occurrences could adversely affect earnings.

The allowance for loan losses requires management to make significant estimates that affect the financial statements. Due to the inherent nature of this estimate, management cannot provide assurance that it will not significantly increase the allowance for loan losses, which could materially and adversely affect earnings.

Nonperforming assets take significant time to resolve and adversely affect the Company's results of operations and financial condition.

The Company's nonperforming assets adversely affect its net income in various ways. The Company expects to continue to incur additional losses relating to volatility in nonperforming loans. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases credit administration costs. When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related asset to the then fair market value of the collateral less estimated selling costs, which may, and often does, result in a loss. An increase in the level of nonperforming assets also increases the Company's risk profile and may impact the capital levels regulators believe are appropriate in light of such risks. The Company utilizes various techniques such as workouts and restructurings to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect the Company's business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including generation of new loans. There can be no assurance that the Company will avoid further increases in nonperforming loans in the future.

Table of Contents

The Company relies upon independent appraisals to determine the value of the real estate which secures a significant portion of its loans, and the values indicated by such appraisals may not be realizable if the Company is forced to foreclose upon such loans.

A significant portion of the Company's loan portfolio consists of loans secured by real estate. The Company relies upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment which adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of the Company's loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, the Company may not be able to recover the outstanding balance of the loan and will suffer a loss.

If more competitors come into our market area, our business could suffer.

The financial services industry in our market area is highly competitive, with a number of commercial banks, credit unions, insurance companies and stockbrokers seeking to do business with our customers. If there is additional competition from new business or if our existing competitors focus more attention on our market, we could lose customers and our business could suffer.

Additional laws and regulations or revisions and rescission of existing laws and regulations could lead to a significant increase in our regulatory burden.

The Dodd-Frank Act and its implementing regulations have resulted in greater compliance costs and reduced the profitability of some of our products and services. Implementation of the proposed Basel III rules for capital could increase our compliance costs because of the complexity in the risk assessment rules. While the risk appears to have diminished somewhat, both federal and state governments could enact new laws affecting financial institutions that would further increase our regulatory burden and could negatively affect our profits. Likewise, revisions or rescission of existing laws and regulations already implemented may result in additional compliance costs, at least in the short-term or, if done imprudently, could ultimately create economic risks negatively affecting our revenues.

New laws and regulations could limit our sources of noninterest income.

While the risk appears to have diminished somewhat, new laws and regulations could limit our ability to offer certain profitable products and services. This could have a negative effect on the level of noninterest income.

Intense oversight by regulators could result in stricter requirements and higher overhead costs.

Regulators for the Company and the subsidiary bank are tasked with ensuring compliance with applicable laws and regulations. Laws and regulations are subject to a degree of interpretation. The regulatory environment has caused

financial industry regulators to take more extreme interpretations, which could impact the Company's earnings.

Political risks in the U.S. and the rest of the world could negatively affect the financial markets.

Political risks in the U.S. and the rest of the world could affect financial markets and affect fiscal policy which could negatively affect our investment portfolio and earnings.

Our information systems may experience an interruption or security breach.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions of our internet banking, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if they do occur, that they will be adequately addressed.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees, in systems and on networks. The secure processing, maintenance and use of this information is critical to the Company's operations and business strategy. The Company has invested in accepted technologies, and annually reviews its processes and practices that are designed to protect its networks, computers and data from damage or unauthorized access. Despite these security measures, the Company's computer systems experienced two cyber-intrusions, one in May 2016 and one in January 2017 in which certain customer information was compromised, but which did not cause interruption to the Company's normal operations. The Company's computer systems and infrastructure may in the future be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. The occurrence of any failure, interruption or security breach of our communications and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability.

Table of Contents

Cyber-attacks may disarm and/or bypass system safeguards and allow unauthorized access and misappropriation of financial data and assets.

As a financial institution holding company, we are vulnerable to and the target of cyber-attacks that attempt to access our digital technology systems, disarm and/or bypass system safeguards, access customer data and ultimately increase the risk of economic and reputational loss.

The Company experienced two cyber-intrusions, one in May 2016 and one in January 2017 in which certain customer information was compromised. The Company has strengthened its multi-faceted approach to reduce the exposure of our systems to cyber- intrusions, strengthen our defenses against hackers and protect customer accounts and information relevant to customer accounts from unauthorized access. These tools include digital technology safeguards, internal policies and procedures, and employee training.

The Company believes its cybersecurity risk management program addresses the risk from cybersecurity attacks. However, it is not possible to fully eliminate exposure. We may experience human error or have unknown susceptibilities that allow our systems to become victim to a highly-sophisticated cyber-attack. If hackers gain entry to our systems, they may disable other safeguards that limit loss, including limits on the number, amount, and frequency of ATM withdrawals, as well as other loss-prevention or detection measures.

Cybersecurity attacks are probable and may result in additional costs.

The Company has experienced many attempted cybersecurity attacks, of which two resulted in a breach. The Company estimates that the probability of future attempted cyber-attacks is high. To reduce the risk of loss from cyber-attacks and to remediate vulnerabilities discovered through the breach investigations, the Company has incurred costs related to forensic investigations, legal and advisory expenses, insurance premiums, system monitoring and testing, and installing new technological infrastructure and defenses. The Company has implemented or is in the process of implementing every recommendation from the forensic investigations. If the Company experiences another cyber-breach, these costs will increase as well as potential costs for litigation, reputational harm and regulatory costs.

The Company relies on other companies to provide key components of the Company’s business infrastructure.

Third parties provide key components of the Company’s business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problem caused by these third parties, including those resulting from disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher volumes, failures of a vendor to provide services for any reason or poor performance of services, could adversely affect the Company’s ability to deliver products and services to its customers and otherwise conduct its business. Financial or operational difficulties of a third party vendor could also hurt the Company’s operations if those difficulties interface with the vendor’s ability to serve the Company. Replacing these third party vendors could also create significant delay and expense and damage the Company's ability to service its customers resulting in a loss of goodwill. Accordingly, use of such third parties creates an unavoidable inherent risk to the Company’s business operations.

Consumers may increasingly decide not to use the Bank to complete their financial transactions, which would have a material adverse impact on the Company's financial condition and operations.

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

Changes in funding for higher education could materially affect our business.

Two major employers in the Company's market area are Virginia Tech and Radford University, both state-supported institutions. If federal or state support for public colleges and universities wanes, our business may be adversely affected from declines in university programs, capital projects, employment and other related factors.

The Company is dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect the Company's operations and prospects.

The Company currently depends on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company's success also depends in part on the ability to attract and retain additional qualified management personnel. Competition for such personnel is strong and the Company may not be successful in attracting or retaining the personnel it requires.

Table of Contents

Changes in accounting standards could impact reported earnings.

The authorities who promulgate accounting standards, including the Financial Accounting Standards Board, SEC, and other regulatory authorities, periodically change the financial accounting and reporting standards that govern the preparation of the Company's consolidated financial statements. These changes are difficult to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of financial statements for prior periods. Such changes could also require the Company to incur additional personnel or technology costs. Most notably, new guidance on the calculation of credit reserves using current expected credit losses was finalized in June, 2016. The standard will be effective for the Company beginning January 1, 2021. The Company has formed a management committee to prepare for the new standards. The committee has implemented new data collection and has begun the process to run preliminary CECL models along with the incurred loss model currently in use. To implement the new standard, the Company will incur costs related to data collection and documentation, technology and training. The Company expects that implementation could significantly impact our required credit reserves. Other impacts to capital levels, profit and loss and various financial metrics will also result.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the performance of the Company's fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Company's fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

The Company's ability to pay dividends depends upon the results of operations of its subsidiaries.

The Company is a financial holding company and a bank holding company that conducts substantially all of its operations through NBB. As a result, the Company's ability to make dividend payments on its common stock depends primarily on certain federal regulatory considerations and the receipt of dividends and other distributions from NBB. There are various regulatory restrictions on the ability of NBB to pay dividends or make other payments to the Company. Although the Company has historically paid a cash dividend to the holders of its common stock, holders of the common stock are not entitled to receive dividends, and regulatory or economic factors may cause the Company's Board of Directors to consider, among other things, the reduction of dividends paid on the Company's common stock.

While the Company's common stock is currently traded on the NASDAQ Capital Market, it has less liquidity than stocks for larger companies quoted on a national securities exchange.

The trading volume in the Company's common stock on the NASDAQ Capital Market has been relatively low when compared with larger companies listed on the NASDAQ Capital Market or other stock exchanges. There is no assurance that a more active and liquid trading market for the common stock will exist in the future. Consequently,

stockholders may not be able to sell a substantial number of shares for the same price at which stockholders could sell a smaller number of shares. In addition, the Company cannot predict the effect, if any, that future sales of its common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock. Sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, could cause the price of the Company's common stock to decline, or reduce the Company's ability to raise capital through future sales of common stock.

A change in tax rates applicable to the Company may cause impairment of deferred tax assets.

The Company determines deferred income taxes using the balance sheet method. Under this method, each asset and liability is examined to determine the difference between its book basis and its tax basis. The difference between the book basis and the tax basis of each asset and liability is multiplied by the Company's marginal tax rate to determine the net deferred tax asset or liability. If the applicable tax rate changes, the effect of the change on deferred tax assets is recognized as an increase or decrease to income tax expense.

When changes in tax rates and laws are enacted, the company must recognize the changes in the period in which they are enacted. On December 22, 2017, The Tax Cuts and Jobs Act ("the ACT") was signed into law and becomes effective January 1, 2018. The Act will change the Company's applicable tax rate from a 35% marginal rate to a flat 21%. Deferred tax assets were re-valued from 35% to 21% in 2017, with a resulting charge to income tax expense.

Item 1B. Unresolved Staff Comments

There are no unresolved staff comments.

Table of Contents

Item 2. Properties

NBB owns and has a branch bank in NBI's headquarters building located at 101 Hubbard Street, Blacksburg, Virginia. NBB's main office is at 100 South Main Street, Blacksburg, Virginia. NBB owns an additional seventeen branch offices and it leases six branch locations and a loan production office. We believe that existing facilities are adequate for current needs and to meet anticipated growth.

Item 3. Legal Proceedings

NBI, NBB, and NBFS are not currently involved in any material pending legal proceedings. There are no legal proceedings related to cybersecurity.

Item 4. Mine Safety Disclosures

Not applicable.

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the NASDAQ Capital Market under the symbol "NKSH." As of December 31, 2017, there were 660 record stockholders of NBI common stock. The following is a summary of the market price per share and cash dividend per share of the common stock of National Bankshares, Inc. for 2017 and 2016.

Common Stock Market Prices

	2017		2016		Dividends per share	
	High	Low	High	Low	2017	2016
First Quarter	$ 44.40	$ 36.05	$ 35.10	$ 31.75	$ ---	$ ---
Second Quarter	44.75	37.60	37.10	32.32	0.56	0.55
Third Quarter	46.25	36.75	37.49	33.18	---	---
Fourth Quarter	47.70	42.00	45.35	34.00	0.61	0.61

NBI’s primary source of funds for dividend payments is dividends from its bank subsidiary, NBB. Bank dividend payments are restricted by regulators, as more fully disclosed in Note 11 of Notes to Consolidated Financial Statements.

On May 10, 2017, NBI’s Board of Directors approved the repurchase of up to 100,000 shares of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934. During 2017, there were no shares repurchased, and 100,000 shares may yet be purchased under the program.

Table of Contents

Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Composite Index, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2012. These comparisons assume the investment of $100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2012, and the reinvestment of dividends.

	2012	**2013**	**2014**	**2015**	**2016**	**2017**
NATIONAL BANKSHARES, INC.	100	117	100	122	154	165
NASDAQ COMPOSITE INDEX	100	140	161	172	188	244
NASDAQ BANK INDEX	100	144	149	161	223	235

Table of Contents

Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries

Selected Consolidated Financial Data

$ in thousands, except per share data	**Year ended December 31,**				
	2017	**2016**	**2015**	**2014**	**2013**
Selected Income Statement Data:					
Interest income	**$41,260**	$40,930	$42,914	$43,944	$45,670
Interest expense	**4,125**	4,166	4,183	4,899	5,955
Net interest income	**37,135**	36,764	38,731	39,045	39,715
Provision for loan losses	**157**	1,650	2,009	1,641	1,531
Noninterest income	**10,379**	9,932	9,486	9,120	9,222
Noninterest expense	**26,972**	26,152	25,635	24,432	24,299
Income taxes	**6,293**	3,952	4,740	5,178	5,317
Net income	**14,092**	14,942	15,833	16,914	17,790
Per Share Data:					
Basic net income	**2.03**	2.15	2.28	2.43	2.56
Diluted net income	**2.03**	2.15	2.28	2.43	2.55
Cash dividends declared	**1.17**	1.16	1.14	1.13	1.12
Book value	**26.57**	25.62	24.74	23.93	21.00
Selected Balance Sheet Data at End of Year:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**660,144**	639,452	610,711	597,203	587,463
Total securities	**459,751**	440,409	389,288	385,385	347,109
Total assets	**1,256,757**	1,233,942	1,203,519	1,158,798	1,114,561
Total deposits	**1,059,734**	1,043,442	1,018,859	982,428	960,036
Stockholders' equity	**184,896**	178,263	172,114	166,303	145,892
Selected Balance Sheet Daily Averages:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**644,998**	613,366	611,554	584,857	577,746
Total securities	**442,101**	420,915	379,805	361,028	362,334
Total assets	**1,235,754**	1,206,745	1,155,594	1,120,848	1,090,703
Total deposits	**1,038,586**	1,013,787	976,597	957,684	933,482
Stockholders' equity	**184,539**	180,047	171,732	157,832	149,491

Selected Ratios:

Return on average assets	**1.14**	**%**	1.24	%	1.37	%	1.51	%	1.63	%
Return on average equity	**7.64**	**%**	8.30	%	9.22	%	10.72	%	11.90	%
Dividend payout ratio	**57.77**	**%**	54.02	%	50.09	%	46.43	%	43.74	%
Average equity to average assets	**14.93**	**%**	14.92	%	14.86	%	14.08	%	13.71	%
Efficiency ratio[(1)]	**53.08**	**%**	52.17	%	49.41	%	47.08	%	45.99	%

(1) The efficiency ratio is calculated by dividing noninterest expense by noninterest income and net interest income on a fully taxable equivalent basis. The tax rate used to calculate fully taxable equivalent basis is 35%.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

$ in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the results of operations, financial condition, liquidity and capital resources of National Bankshares, Inc. and its subsidiaries (the "Company"). The discussion should be read in conjunction with the material presented in Item 8, "Financial Statements and Supplementary Data," of this Form 10-K.

Subsequent events have been considered through the date on which the Form 10-K was issued.

Cautionary Statement Regarding Forward-Looking Statements

We make forward-looking statements in this Form 10-K that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management's views and assumptions as of the date of this report. The words "believes," "expects," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends," or other similar words or terms are intended to identify forward-looking statements.

These forward-looking statements are based upon or are affected by factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. These factors include, but are not limited to, changes in:

- interest rates,
- general economic conditions,
- the legislative/regulatory climate,
- monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Consumer Financial Protection Bureau and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and other financial reform legislation,
- unanticipated increases in the level of unemployment in the Company's trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company's trade area,
- the real estate market in the Company's trade area,
- the Company's technology initiatives, and
- applicable accounting principles, policies and guidelines.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained in this report. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report. This discussion and analysis should be read in conjunction with the description of our “Risk Factors” in Item 1A. of this Form 10-K.

If the national economy or the Company’s market area experience a downturn, it is likely that unemployment will rise and that other economic indicators will negatively impact the Company’s trade area. Because of the importance to the Company’s markets of state-funded universities, cutbacks in the funding provided by the Commonwealth could also negatively impact employment. This could lead to a higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company’s business and professional customers. An economic downturn could have an adverse effect on all financial institutions, including the Company.

Critical Accounting Policies

General

The Company’s financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, financial information based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. Although the economics of the Company’s transactions may not change, the timing of events that would impact the transactions could change.

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable losses inherent in our loan portfolio. The allowance is funded by the provision for loan losses, reduced by charge-offs of loans and increased by recoveries of previously charged-off loans. The determination of the allowance is based on two accounting principles, Accounting Standards Codification (“ASC”) Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss is reasonably estimable, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

Table of Contents

Probable losses are accrued through two calculations, individual evaluation of impaired loans and collective evaluation of the remainder of the portfolio. Impaired loans are larger non-homogeneous loans for which there is a probability that collection will not occur according to the loan terms, as well as loans whose terms have been modified in a troubled debt restructuring. Impaired loans that are not TDR's with an estimated impairment loss are placed on nonaccrual status. TDR's with an impairment loss may accrue interest if they have demonstrated six months of timely payment performance.

Impaired loans

Impaired loans are identified through the Company's credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan's fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral ("collateral method"), the present value of future cash flows ("cash flow method"), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is imminent and to loans for which the fair value of collateral is a more reliable estimate of fair value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of $250 or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of $100 or greater and secured by one piece of collateral. Collateral-method impaired loans with principal balances below $100, or if secured by multiple pieces of collateral, below $250, are valued using an internal evaluation.

Appraisals and internal valuations provide an estimate of market value. Appraisals must conform to the Uniform Standards of Professional Appraisal Practice ("USPAP") and are prepared by an independent third-party appraiser who is certified and licensed and who is approved by the Company. Appraisals may incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value.

Internal evaluations are prepared by third party providers and reviewed by employees of the Company who are independent of the loan origination, operation, management and collection functions. Evaluations provide a property's market value based on the property's current physical condition and characteristics and the economic market conditions that affect the collateral's market value. Evaluations incorporate multiple sources of data to arrive at a property's market value, including physical inspection, independent third-party automated tools, comparable sales analysis and local market information.

Updated appraisals or evaluations are ordered when the loan becomes impaired if the appraisal or evaluation on file is more than twelve months old. Appraisals and evaluations are reviewed for propriety and reasonableness and may be discounted if the Company determines that the value exceeds reasonable levels. If an updated appraisal or evaluation has been ordered but has not been received by a reporting date, the fair value may be based on the most recent available appraisal or evaluation, discounted for age.

The appraisal or evaluation value for a collateral-dependent loan for which recovery is expected solely from the sale of collateral is reduced by estimated selling costs. Estimated losses on collateral-dependent loans, as well as any other impairment loss considered uncollectible, are charged against the allowance for loan losses. Impairment losses that are not considered uncollectible or for loans that are not collateral dependent are accrued in the allowance. Impaired loans with partial charge-offs are maintained as impaired until the remaining balance is satisfied. Smaller homogeneous

impaired loans that are not troubled debt restructurings and are not part of a larger impaired relationship are collectively evaluated.

Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment with at least six months of consecutive timely payment performance.

Collectively-evaluated loans

Non-impaired loans and smaller homogeneous impaired loans that are not troubled debt restructurings and not part of a larger impaired relationship are grouped by portfolio segments. Portfolio segments are further divided into smaller loan classes. Loans within a segment or class have similar risk characteristics.

Probable loss is determined by applying historical net charge-off rates as well as additional percentages for trends and current levels of quantitative and qualitative factors. Loss rates are calculated for and applied to individual classes by averaging loss rates over the most recent 8 quarters. The look-back period of 8 quarters is applied consistently among all classes.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance (“class loss rate”), and total net charge-offs for the class as a percentage of average classified loans in the class (“classified loss rate”). Classified loans are those with risk ratings that indicate credit quality is “substandard”, “doubtful” or “loss”. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to collectively-evaluated non-classified loan balances, and classified historical loss rates are applied to collectively-evaluated classified loan balances.

Qualitative factors are evaluated and allocations are applied to each class. Qualitative factors include delinquency rates, loan quality and concentrations, loan officers’ experience, changes in lending policies and changes in the loan review process. Economic factors such as unemployment rates, bankruptcy rates and others are evaluated, with standard allocations applied consistently to relevant classes.

Table of Contents

The Company accrues additional allocations for criticized loans within each class and for loans designated high risk. Criticized loans include classified loans as well as loans rated “special mention”. Loans rated special mention indicate weakened credit quality but to a lesser degree than classified loans. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with terms that require interest only payments. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

Estimation of the allowance for loan losses

The estimation of the allowance involves analysis of internal and external variables, methodologies, assumptions and our judgment and experience. Key judgments used in determining the allowance for loan losses include internal risk rating determinations, market and collateral values, discount rates, loss rates, and our view of current economic conditions. These judgments are inherently subjective and our actual losses could be greater or less than the estimate. Future estimates of the allowance could increase or decrease based on changes in the financial condition of individual borrowers, concentrations of various types of loans, economic conditions or the markets in which collateral may be sold. The estimate of the allowance accrual determines the amount of provision expense and directly affects our financial results.

The estimate of the allowance for December 31, 2017 considered market and portfolio conditions during 2017 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended December 31, 2017. If the economy experiences a downturn, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 5 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

Goodwill

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company’s most recent impairment test was performed in the fourth quarter of 2017. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. The Company opted not to perform the preliminary assessment. The Company’s goodwill impairment analysis considered three valuation techniques appropriate to the measurement. The first technique uses the Company’s market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to the Company; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to the Company. Each measure indicated that the Company’s fair value exceeded its book value, validating that goodwill is not impaired.

Certain key judgments were used in the valuation measurement. Goodwill is held by the Company’s bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company’s assets are comprised of the subsidiary bank’s equity, the Company’s market capitalization was used to estimate the Bank’s market capitalization. Other judgments include the assumption that the companies and transactions used as comparables for the second and third technique were appropriate to the estimate of the Company’s

fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.

Other Real Estate Owned ("OREO")

Real estate acquired through, or in lieu of, foreclosure is held for sale and is stated at fair value of the property, less estimated disposal costs, if any. Any excess of cost over the fair value less costs to sell at the time of acquisition is charged to the allowance for loan losses. The fair value is reviewed periodically by management and any write-downs are charged against current earnings. Accounting policy and treatment is consistent with accounting for impaired loans described above.

Pension Plan

The Company's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the estimated return on plan assets and the anticipated rate of compensation increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

Table of Contents

Other Than Temporary Impairment of Securities ("OTTI")

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 (i) the Company intends to sell the security or (ii) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more likely than not that the Company 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 basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity 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 net income. The Company regularly reviews each investment security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the Company's 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.

Overview

National Bankshares, Inc. is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. The National Bank of Blacksburg ("NBB"), which does business as National Bank from twenty-five office locations and one loan production office, is a community bank. NBB is the source of nearly all of the Company's revenue. National Bankshares Financial Services, Inc. ("NBFS") does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

National Bankshares, Inc. common stock is listed on the NASDAQ Capital Market and is traded under the symbol "NKSH." National Bankshares, Inc. has been included in the Russell Investments Russell 3000 and Russell 2000 Indexes since June 29, 2009.

Performance Summary

The following table presents NBI's key performance ratios for the years ending December 31, 2017 and December 31, 2016:

	12/31/17		12/31/16	
Return on average assets	**1.14**	**%**	1.24	%
Return on average equity	**7.64**	**%**	8.30	%
Basic net earnings per common share	**$ 2.03**		$ 2.15	
Fully diluted net earnings per common share	**$ 2.03**		$ 2.15	
Net interest margin (1)	**3.45**	**%**	3.51	%
Noninterest margin (2)	**1.34**	**%**	1.36	%

(1) Net Interest Margin – Year-to-date tax equivalent net interest income divided by year-to-date average earning assets.

(2) Noninterest Margin – Noninterest expense (excluding the provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The return on average assets for the year ended December 31, 2017 was 1.14%, a decrease from 1.24% for the year ended December 31, 2016. The return on average equity decreased from 8.30% for the year ended December 31, 2016 to 7.64% for the year ended December 31, 2017.

The net interest margin decreased from 3.51% at year-end 2016 to 3.45% at December 31, 2017. The net interest margin benefitted from Federal Reserve interest rate increases, but reflected downward repricing of loans for competitive purposes, as well as the Company’s asset liability management practices.

The noninterest margin decreased from 1.36% to 1.34% over the same period, while basic net earnings per common share decreased from $2.15 for the year ended December 31, 2016 to $2.03 for the year ended December 31, 2017.

Table of Contents

Growth

NBI's key growth indicators are shown in the following table:

	12/31/17	12/31/16
Securities	**$459,751**	$440,409
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**660,144**	639,452
Deposits	**1,059,734**	1,043,442
Total assets	**1,256,757**	1,233,942

Total assets experienced growth in 2017, funded by increases in customer deposits. Customer deposits grew $16,292 or 1.56% from December 31, 2016, with increases mainly from municipal deposits and individuals seeking to safeguard principal by avoiding more volatile investments in financial markets. The liquidity provided by customer deposits supported growth in loans of $20,692 or 3.24%. Securities increased by $19,342 or 4.39%.

In both 2017 and 2016, the Company's growth was internally generated and was not the result of acquisitions or other borrowings.

Asset Quality

Key indicators of NBI's asset quality are presented in the following table:

	12/31/17		12/31/16	
Nonperforming loans[1]	**$ 2,769**		$ 5,855	
Loans past due 90 days or more and accruing	**51**		63	
Other real estate owned	**2,817**		3,156	
Allowance for loan losses to loans[2]	**1.19**	**%**	1.28	%
Net charge-off ratio	**0.08**	**%**	0.26	%

(1) Nonperforming loans include nonaccrual loans plus restructured loans in nonaccrual status. Accruing restructured loans are not included.

(2) Loans are net of unearned income and deferred fees and costs.

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. At December 31, 2017, nonperforming loans were $2,769 or 0.41% of loans net of unearned income and deferred fees and costs. This compares to $5,855 or 0.90% at December 31, 2016. Loans past due 90 days or more and still accruing at year-end 2017 totaled $51, a decrease of $12 or 19.05%, from $63 at December 31, 2016. The net charge-off ratio decreased from 0.26% for the year ended December 31, 2016 to 0.08% for the year ended December 31, 2017, while other real estate owned decreased $339 for the same period.

The Company's risk analysis determined an allowance for loan losses of $7,925 at December 31, 2017, resulting in a provision for the year of $157. This compares with an allowance for loan losses of $8,300 as of December 31, 2016, and a provision of $1,650 for the year ended December 31, 2016. The ratio of the allowance for loan losses to loans decreased to 1.19%, from 1.28% at December 31, 2016. The methodology for determining the allowance for loan losses relies on historical charge-off trends, modified by trends in nonperforming loans and economic indicators. More information about the level and calculation methodology of the allowance for loan losses is provided in "Provision and Allowance for Loan Losses", "Balance Sheet – Loans – Risk Elements," "Balance Sheet – Loans – Troubled Debt Restructurings," as well as Notes 1 and 5 to the financial statements.

Sufficient resources have been dedicated to working out problem assets, and exposure to loss is somewhat mitigated because most of the nonperforming loans are collateralized. More information about nonaccrual and past due loans is provided in "Balance Sheet – Loans – Risk Elements" and Note 5 to the financial statements. The Company continues to monitor risk levels within the loan portfolio and expects that any further increase in the allowance for loan losses would be the result of the refinement of loss estimates and would not dramatically affect net income.

Net Interest Income

Net interest income for the year ended December 31, 2017 was $37,135, an increase of $371, or 1.01%, when compared to the prior year. The net interest margin for 2017 was 3.45%, compared to 3.51% for 2016. Total interest income for the period ended December 31, 2017 was $41,260, an increase of $330 from the period ended December 31, 2016. Interest expense declined by $41 during the same time frame, from $4,166 for the year ended December 31, 2016 to $4,125 for the year ended December 31, 2017. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates and because of the continued migration of time deposits to lower-cost non-time deposits. In addition, low-rate interest-bearing deposits volume increased substantially. Please refer to the section titled "Analysis of Changes In Interest Income and Interest Expense" for further information related to rate and volume changes.

Table of Contents

The amount of net interest income earned is affected by various factors, including changes in market interest rates due to the Federal Reserve Board's monetary policy, U.S. fiscal policy, the level and composition of the earning assets and the composition of interest-bearing liabilities. The Company has the ability to respond over time to interest rate movements and reduce volatility in the net interest margin. However, the frequency and/or magnitude of changes in market interest rates are difficult to predict and may have a greater impact on net interest income than adjustments by management.

The Federal Reserve increased its target federal funds rate by 25 basis points in December 2016 and raised rates by 25 basis points again in March, June and December, 2017, ending the year at a target of 1.50%. The rate increases positively affected the yield on the Company's interest-bearing deposits in other banks for 2017. The yield on interest-bearing deposits increased from 0.52% for 2016 to 1.10% for 2017. However, the interest rate environment during 2017 is still considered to be relatively low by historical standards.

The primary source of funds used to support the Company's interest-earning assets is deposits. Deposits are obtained in the Company's trade area through traditional marketing techniques. Other funding sources, such as the Federal Home Loan Bank, while available, are only used occasionally. The cost of funds is dependent on interest rate levels and competitive factors. This limits the ability of the Company to react to interest rate movements.

Federal Reserve policies and market forces influence the Company's net interest margin. Because interest rates continue at relatively low levels, the Company expects that interest rates will likely increase in the future. The Company anticipates any rate increases will have a positive impact on the Company's future net interest income. Management cannot predict the timing and level of interest rate movements.

Table of Contents

Analysis of Net Interest Earnings

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the interest earned or paid, the average yield or rate on the daily average balance outstanding, net interest income and net yield on average interest-earning assets for the years indicated.

	December 31, 2017			**December 31, 2016**			**December 31, 2015**		
	Average Balance	**Interest**	**Average Yield/ Rate**	**Average Balance**	**Interest**	**Average Yield/ Rate**	**Average Balance**	**Interest**	**Average Yield/ Rate**
Interest-earning assets:									
Loans, net of unearned income and deferred fees and costs [1][2][3][4]	**$653,756**	**$30,593**	**4.68 %**	$622,239	$29,993	4.82 %	$620,547	$31,122	5.02 %
Taxable securities[5]	**313,255**	**5,711**	**1.82 %**	280,842	5,910	2.10 %	234,398	6,776	2.89 %
Nontaxable securities [1][5]	**131,762**	**7,462**	**5.66 %**	139,429	7,932	5.69 %	147,895	8,425	5.70 %
Interest-bearing deposits	**71,603**	**791**	**1.10 %**	102,819	532	0.52 %	96,677	254	0.26 %
Total interest-earning assets	**$1,170,376**	**$44,557**	**3.81 %**	$1,145,329	$44,367	3.87 %	$1,099,517	$46,577	4.24 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	**$598,661**	**$3,344**	**0.56 %**	$567,971	$3,144	0.55 %	$525,864	$2,916	0.55 %
Savings deposits	**140,997**	**244**	**0.17 %**	134,982	315	0.23 %	127,534	408	0.32 %
Time deposits	**120,220**	**537**	**0.45 %**	140,490	707	0.50 %	163,370	859	0.53 %
Total interest-bearing liabilities	**$859,878**	**$4,125**	**0.48 %**	$843,443	$4,166	0.49 %	$816,768	$4,183	0.51 %
Net interest income[1] and interest rate spread		**$40,432**	**3.33 %**		$40,201	3.38 %		$42,394	3.73 %
Net yield on average interest-earning assets			**3.45 %**			3.51 %			3.86 %

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three years presented.
(2) Loan fees of $303 in 2017, $360 in 2016 and $448 in 2015 are included in total interest income.
(3) Nonaccrual loans are included in average balances for yield computations.
(4) Includes loans held for sale.
(5) Daily averages are shown at amortized cost.

The following table reconciles net interest income on a fully-taxable equivalent basis to net interest income on a GAAP basis.

	December 31,		
	2017	**2016**	**2015**
Net interest income, fully taxable equivalent basis	**$40,432**	$40,201	$42,394
Less: taxable equivalent adjustment	**(3,297)**	(3,437)	(3,663)
Net interest income	**$37,135**	$36,764	$38,731

Table of Contents

Analysis of Changes in Interest Income and Interest Expense

The Company's primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other funds. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate).

	2017 Over 2016 Changes Due To			2016 Over 2015 Changes Due To		
	Rates[2]	Volume[2]	Net Dollar Change	Rates[2]	Volume[2]	Net Dollar Change
Interest income: [1]						
Loans	$(891)	$ 1,491	$ 600	$(1,214)	$ 85	$(1,129)
Taxable securities	(839)	640	(199)	(2,055)	1,189	(866)
Nontaxable securities	(36)	(434)	(470)	(11)	(482)	(493)
Interest-bearing deposits	460	(201)	259	261	17	278
Increase (decrease) in income on interest-earning assets	$(1,306)	$ 1,496	$ 190	$(3,019)	$ 809	$(2,210)
Interest expense:						
Interest-bearing demand deposits	$29	$ 171	$ 200	$(5)	$ 233	$228
Savings deposits	(84)	13	(71)	(116)	23	(93)
Time deposits	(74)	(96)	(170)	(36)	(116)	(152)
Increase (decrease) in expense of interest-bearing liabilities	$(129)	$ 88	$ (41)	$(157)	$ 140	$(17)
Increase (decrease) in net interest income	$(1,177)	$ 1,408	$ 231	$(2,862)	$ 669	$(2,193)

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2017, 2016 and 2015.

(2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

Net interest income on a taxable-equivalent basis increased $231 when 2017 is compared with 2016. Total interest income on a taxable equivalent basis increased $190 while total interest expense declined by $41. Declining yields impacted net interest income by $1,177, offset by increases due to volume of $1,408.

The Federal Reserve increased rates by 25 basis points in December 2016 and three times in 2017. The rate increases had a direct and immediate effect on the Company's interest-bearing deposits. Interest income on interest-bearing deposits increased $460 due to rates, but declined by $201 due to reduced volume, for a net increase of $259 when 2017 is compared with 2016. The Company's securities and loan portfolios did not experience a similar increase in

yields due to the longer-term nature of the portfolios, reinvestment opportunities in the bond market and the competitive lending environment of the Company's market area.

Taxable equivalent interest income on loans increased $600 when 2017 and 2016 are compared. The average balance of loans increased from $622,239 in 2016 to $653,756 in 2017, increasing interest income by $1,491. Lower yields reduced interest income by $891.

Interest income on taxable securities decreased $199 when 2017 is compared with 2016, the result of an increase of $640 due to volume offset by a decline of $839 due to rates. Taxable-equivalent interest on non-taxable securities declined $36 due to rates and $434 due to volume. The low interest rate environment in 2016 resulted in a large number of called securities at a time when re-investment opportunities were less attractive than the yields on the original called securities. The lower yields available upon reinvestment of the call securities negatively impacted income from securities during 2017. Because of low yields in the securities markets and a highly competitive loan environment, the Company priced deposits accordingly.

Interest on time deposits declined $170 from 2016 to 2017, with a decline of $74 due to rates and $96 due to decreased volume. See "Net Interest Income" for additional information related to the decline in interest expense.

When 2016 is compared with 2015, taxable-equivalent net interest income declined by $2,193. Total interest expense declined by $17, while interest income on a taxable-equivalent basis decreased $2,210. Declining yields impacted net interest income by $2,862, offset by increases due to favorable changes in volume of $669.

Lower interest rates led to a decline of $1,214 in interest income from loans. The average balance of loans increased from $620,547 in 2015 to $622,239 in 2016, causing an increase in interest income of $85.

Interest income on taxable securities decreased $2,055 due to rates, offset by an increase of $1,189 due to average volume, for a net decrease of $866 compared to 2015. Interest on non-taxable securities on a fully-taxable equivalent basis declined $11 due to rates and $482 due to volume. Because of low yields in the securities markets and a highly competitive loan environment, the Company priced deposits accordingly. Interest on time deposits declined $152 from 2015 to 2016, with a decline of $36 due to rates and $116 due to decreased volume.

Table of Contents

Interest Rate Sensitivity

The Company considers interest rate risk to be a significant risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Among the tools available to management is interest rate sensitivity analysis, which provides information related to repricing opportunities. Interest rate shock simulations indicate potential economic loss due to future interest rate changes. Shock analysis is a test that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on the return on average assets and the return on average equity projected at December 31, 2017 and 2016. For purposes of this analysis, noninterest income and expenses are assumed to be flat.

Rate Shift (bp)	Return on Average Assets				Return on Average Equity			
	2017		2016		2017		2016	
300	**1.37**	**%**	1.23	%	**9.13**	**%**	8.37	%
200	**1.40**	**%**	1.24	%	**9.28**	**%**	8.42	%
100	**1.42**	**%**	1.24	%	**9.42**	**%**	8.45	%
(-)100	**1.37**	**%**	1.13	%	**9.06**	**%**	7.70	%
(-)200	**1.23**	**%**	1.05	%	**8.17**	**%**	7.20	%
(-)300	**1.25**	**%**	1.12	%	**8.33**	**%**	7.57	%

Simulation analysis is another tool available to the Company to test asset and liability management strategies under rising and falling rate conditions. As a part of the simulation process, certain estimates and assumptions must be made. These include, but are not limited to, asset growth, the mix of assets and liabilities, rate environment and local and national economic conditions. Asset growth and the mix of assets can, to a degree, be influenced by management. Other areas, such as the rate environment and economic factors, cannot be controlled. In addition, competitive pressures can make it difficult to price deposits and loans in a manner that optimally minimizes interest rate risk. Therefore, actual results may vary materially from any particular forecast or shock analysis. This shortcoming is offset somewhat by the periodic reforecasting of the balance sheet to reflect current trends and economic conditions. Shock analysis must also be updated periodically as a part of the asset and liability management process.

Noninterest Income

	Year Ended December 31, 2017	December 31, 2016	December 31, 2015
Service charges on deposits	**$2,776**	$ 2,458	$ 2,250
Other service charges and fees	**205**	212	215
Credit card fees	**3,948**	3,798	3,861
Trust fees	**1,530**	1,346	1,229

Bank-owned life insurance income	**758**	597	603
Other income	**1,148**	1,289	1,295
Realized securities gains	**14**	232	33
Total noninterest income	**$10,379**	$ 9,932	$ 9,486

Service charges on deposit accounts totaled $2,776 for the year ended December 31, 2017. This is an increase of $318, or 12.94%, from $2,458 for the year ended December 31, 2016. Service charges on deposit accounts increased $208, or 9.24%, from 2015 to 2016. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2017 increase resulted primarily from an increase of $325 in non-sufficient funds and overdraft fees due to implementation of a new overdraft privilege program during the second half of 2016. The 2016 increase resulted primarily from an increase of $224 in non-sufficient funds and overdraft fees due to implementation of the overdraft privilege program.

Other service charges and fees include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees from letters of credit and income from commissions on the sale of credit life, accident and health insurance. These fees were $205 for the year ended December 31, 2017, a decrease of $7, or 3.30%, from the $212 for 2016. The total for the year ended December 31, 2016 was $3 below the $215 posted for the year ended December 31, 2015.

Credit card fees for the year ended December 31, 2017, were $150 above the $3,798 reported for the year ended December 31, 2016. From 2015 to 2016, credit card fees decreased $63, or 1.63%. Credit card fees are dependent on the volume of transactions.

Table of Contents

Trust fees at $1,530 increased by $184 or 13.67% when the years ended December 31, 2017 and 2016 are compared. For the year ended December 31, 2016 trust fees were $1,346, an increase of $117, or 9.52%, from 2015. Trust fees are generated from a number of different types of accounts, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income varies depending on the number and type of accounts under management and financial market conditions. The mix of account types also affected the level of trust fees in 2016 and 2017.

Noninterest income from bank-owned life insurance (BOLI) increased, from $597 for the year ended December 31, 2016 to $758 for 2017. The Company purchased an additional $10 million in BOLI in June 2017. BOLI income for the year ended December 31, 2015 was $603. Income from bank-owned life insurance was affected by the performance of the variable rate policies, which has not varied significantly.

Other income is income from smaller balance accounts that cannot be classified in another category. Some examples include gains on mortgage loans sold, net gains from the sale of fixed assets and revenue from investment and insurance sales. Other income for 2017 was $1,148, a decrease of $141, or 10.94%, when compared with $1,289 for the year ended December 31, 2016. In December 2017, the Company sold its Marion branch office and realized a gain on the sale of fixed assets of $134. This was offset by a decline of $69 in the gain on the sale of mortgage loans due to lower volume, and a decline of $230 due to a one-time vendor signing incentive received in 2016. Other income decreased slightly from 2015 to 2016.

During 2017, the Company sold a small investment in community bank stock that resulted in a gain of $4. All other realized gains and losses on securities during 2017, 2016 and 2015 resulted from calls of securities. The Company did not sell any securities in 2016 or 2015.

Noninterest Expense

	Year Ended December 31, 2017	**December 31, 2016**	**December 31, 2015**
Salaries and employee benefits	**$13,746**	$ 12,792	$ 12,522
Occupancy, furniture and fixtures	**1,820**	1,849	1,743
Data processing and ATM	**2,275**	2,186	1,657
FDIC assessment	**364**	476	546
Credit card processing	**2,748**	2,782	2,692
Intangibles amortization	**68**	257	999
Net costs of other real estate owned	**205**	472	608
Franchise taxes	**1,315**	1,296	1,288
Other operating expenses	**4,431**	4,042	3,580
Total noninterest expense	**$26,972**	$ 26,152	$ 25,635

Salary and benefits expense increased $954, or 7.46%, from $12,792 for the year ended December 31, 2016 to $13,746 for 2017. Employee salaries increased $256 or 2.63% which was the result of normal staffing and

compensation decisions. Expense associated with the health insurance reserve increased $419. The Company participates in a “self-funded” insurance plan and reserves amounts based on employee health insurance usage and calculated projections. In 2016, the Company benefitted from refunds due to a change in the calculation of the required minimum reserve and from positive claims history. The Company began in 2017, a new incentive compensation program for senior employees, which contributed $280 to the increase. The increases were offset by a $101 decrease in salary expense related to deferred costs associated with loan production. Salary and benefits expense increased $270, or 2.16%, from $12,522 for the year ended December 31, 2015 to $12,792 for 2016. From 2015 to 2016, employee salaries increased $695 or 7.70%, which were the result of normal staffing and compensation decisions. This was offset by a $680 reduction in fringe benefits and a reduction of $171 in BOLI and salary continuation expenses.

Occupancy, furniture and fixtures expense was $1,820 for the year ended December 31, 2017, a decrease of $29, or 1.57%, from the prior year. The decrease stemmed from higher expenditures on security equipment and building maintenance in the previous year. The 2016 total was $1,849, an increase of $106, or 6.08%, from the $1,743 reported at year-end 2015.

Data processing and ATM expense was $2,275 in 2017, $2,186 in 2016 and $1,657 in 2015. The increase of $89 or 4.07% from 2016 to 2017 was due to increased maintenance expense associated with infrastructure upgrades. The Company is committed to maintaining up-to-date technology in a cost-effective manner.

When the years ended December 31, 2017 and December 31, 2016 are compared, the Federal Deposit Insurance Corporation assessment expense decreased $112 or 23.53%. The total expense for 2017 was $364, which compares with $476 for 2016. The FDIC assessment is accrued based on a method provided by the FDIC. The FDIC’s Deposit Insurance Fund reserve ratio reached a target threshold during the second quarter of 2016, resulting in lower FDIC insurance expense for many federally insured institutions. The FDIC assessment expense for the year ended December 31, 2016 decreased $70 from $546 for 2015.

Credit card processing expense was $2,748 for the period ended December 31, 2017, a decrease of $34, or 1.22% from 2016’s total of $2,782. Credit card processing expense in 2016 increased $90, or 3.34% from 2015. This expense is driven by the volume of credit card, debit card and merchant account transactions and by the level of merchant discount fees. It is subject to a degree of variability.

Table of Contents

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2017 decreased from 2016 by $189 or 73.54%. The decrease in core deposit intangibles amortization is due to certain core deposit intangibles becoming fully amortized in late 2015, the first half of 2016, and the first quarter of 2017. The expense for intangibles amortization decreased $742 from 2015 to 2016.

Net costs of other real estate owned decreased from $472 for the period ended December 31, 2016 to $205 for the year ended December 31, 2017. From 2015 to 2016, net costs of other real estate owned decreased $136 from $608. This expense category varies with the number of foreclosed properties owned by NBB and with the expense associated with each. It includes write-downs on other real estate owned plus other costs associated with carrying these properties, as well as net gains or losses on the sale of other real estate. In 2017, write-downs on other real estate were $113. This compares with $268 in 2016 and $440 in 2015. Other real estate is initially accounted for at fair value less estimated costs to sell using current valuations, which include appraisals, real estate evaluations and realtor market opinions. If new valuation information indicates a decline from the initial basis, the Company records a write-down. Other costs for these properties in 2017 were $80, compared with $118 in 2016. The Company recorded a loss of $12 on the sale of OREO in 2017 and a loss of $86 for 2016. The Company’s market area is showing mixed economic signs, with some favorable indicators and some unfavorable indicators, and we anticipate that there may be additional foreclosures in the future. The Company currently does not have any loans in process of foreclosure.

Franchise taxes were $1,315 for the period ended December 31, 2017 and $1,296 for 2016, an increase of $19 or 1.47%. Franchise tax expense increased $8 in 2016 from $1,288 in 2015. State bank franchise taxes are based upon NBB’s total equity, which increased in both 2016 and 2017.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs and charitable donations. For the year ended December 31, 2017, other operating expenses were $4,431. This compares with $4,042 for 2016 and $3,580 for 2015. The $389 increase from 2016 to 2017 was due to a loss of $189 resulting from a wire fraud and an increase in expenses associated with the overdraft program, legal fees, and audit and consulting services. The $462 increase from 2015 to 2016 was primarily the result of the recognition of $347 in bankcard losses.

Cybersecurity Risks and Incidents

The Company treats cybersecurity risk seriously. The Company has a program to identify, mitigate and manage its cybersecurity risks. The program includes penetration testing and vulnerability assessment, technological defenses such as antivirus software, patch management, and firewall management, as well as ongoing employee training. In 2017, the Company also implemented additional email and web protections, an intrusion prevention system and an additional targeted cybersecurity insurance policy. The costs of these measures were $134 for the twelve months ended December 31, 2017 and $66 for the twelve months ended December 31, 2016. These costs are included in various categories of noninterest expense.

The Company experienced two intrusions to its digital systems, one in May 2016 and one in January 2017. Hackers and related organized criminal groups obtained unauthorized access to certain customer accounts. The attacks disabled certain systems protections, including limits on the number, amount, and frequency of ATM withdrawals. The attacks resulted in the theft of funds disbursed through ATMs. In the May 2016 attack, hackers accessed customer funds and in the January 2017 intrusion, the hackers artificially inflated account balances and did not access customer funds. The

Company notified all affected customers, and restored all funds so that no customer experienced a loss.

The Company retained a nationally recognized firm to investigate and remediate the May 2016 intrusion and a separate nationally recognized firm to investigate and remediate the January 2017 intrusion. The firms provided the Company with recommendations concerning its systems and procedures. The Company adopted and implemented all of the recommendations resulting from the investigation of the May 2016 intrusion and has implemented most of the recommendations from the investigation of the January 2017 intrusion, with targeted completion for all such recommendations in 2018.

The financial impact of the attacks include the amount of the theft, as well as costs of investigation and remediation. The theft of funds totaled $570 in the May 2016 attack and $1,838 in the January 2017 attack. The Company recognized an estimated loss of $347 in 2016 within other operating expenses, and currently recognizes an insurance receivable in other assets of $2,061. The Company filed an insurance claim in 2017 for both of the breaches and is awaiting a response from the insurance company. The Company has had no adverse communication from the insurance company. Costs for investigation, remediation, and legal consultation totaled $407 in 2017 and $46 in 2016. As of December 31, 2017, the Company has appropriately accounted for the breaches. There has been no litigation to date associated with the breaches.

We have deployed a multi-faceted approach to limit the risk and impact of unauthorized access to customer accounts and to information relevant to customer accounts. We use digital technology safeguards, internal policies and procedures, and employee training to reduce the exposure of our systems to cyber-intrusions. However, it is not possible to fully eliminate exposure. The potential for financial and reputational losses due to cyber-breaches is increased by the possibility of human error, unknown system susceptibilities, and the rising sophistication of cyber-criminals to attack systems, disable safeguards and gain access to accounts and related information. The company has adopted new protections and invested additional resources to increase its security.

Table of Contents

Income Taxes

Income tax expense for 2017 was $6,293 compared to $3,952 in 2016 and $4,740 in 2015. During the three years reported, the Company's marginal tax rate was 35%. The Company's effective tax rates for 2017, 2016 and 2015 were 30.87%, 20.92% and 23.04%, respectively. The expected income tax expense based on the Company's marginal tax rate differs from the actual income tax expense due to tax exempt income on municipal securities and loans as well as the re-valuation of deferred tax assets. On December 22, 2017, the Tax Cuts and Jobs Act ("the Act") was enacted and is effective January 1, 2018. The Act will reduce the Company's tax rate to 21%. As a result of the change in the Company's future tax rate, generally accepted accounting principles in the United States ("GAAP") require revaluation in 2017 of deferred tax assets to the rate at which they will be realized. During the fourth quarter, the Company recognized a revaluation adjustment of $1.56 million, with a corresponding charge to income tax expense. See Note 10 of the Notes to Consolidated Financial Statements for addition information relating to income taxes.

Effects of Inflation

The Company's consolidated statements of income generally reflect the effects of inflation. Since interest rates, loan demand and deposit levels are related to inflation, the resulting changes are included in net income. The most significant item which does not reflect the effects of inflation is depreciation expense. Historical dollar values used to determine depreciation expense do not reflect the effects of inflation on the market value of depreciable assets after their acquisition.

Provision and Allowance for Loan Losses

The Company's risk analysis at December 31, 2017 determined an allowance for loan losses of $7,925 or 1.19% of loans net of unearned income and deferred fees and costs, a decrease from $8,300 or 1.28% at December 31, 2016. The determination of the appropriate level for the allowance for loan losses resulted in a provision for loan losses of $157 for the twelve months ended December 31, 2017, compared with $1,650 for the twelve months ended December 31, 2016. To determine the appropriate level of the allowance for loan losses, the Company considers credit risk for certain loans designated as impaired and for non-impaired ("collectively evaluated") loans.

Individually evaluated impaired loans totaled $11,924 on a gross basis and $11,919 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $177 at December 31, 2017. Individually evaluated impaired loans at December 31, 2016 were $9,173 on a gross basis and $9,168 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $26. The specific allocation is determined based on criteria particular to each impaired loan.

Collectively evaluated loans totaled $656,758 on a gross basis and $656,150 net of unearned income and deferred fees and costs, with an allowance of $7,748 or 1.18% at December 31, 2017. At December 31, 2016, collectively evaluated

loans totaled $639,373 on a gross basis and $638,584 net of unearned income and deferred fees and costs, with an allowance of $8,274 or 1.30%.

For collectively evaluated loans, the Company applies to each loan class a historical net charge-off rate, adjusted for qualitative factors that influence credit risk. Qualitative factors evaluated for impact to credit risk include economic measures, asset quality indicators, loan characteristics, and internal Bank policies and management.

Net charge-off rates for each class are averaged over 8 quarters (2 years) to determine the historical net charge off rate applied to each class of collectively evaluated loans. Net charge-offs for the twelve months ended December 31, 2017 were $532 or 0.08% of average loans, an improvement from $1,647 or 0.26% for the twelve months ended December 31, 2016. Net charge-offs for the twelve months ended December 31, 2015 were $1,975 or 0.32% of loans. Increases in the net charge-off rate increase the required allowance for collectively-evaluated loans, while decreases in the net charge-off rate decrease the required allowance for collectively-evaluated loans.

Economic factors influence credit risk and impact the allowance for loan loss. The Company considers economic indicators that impact its markets, including: unemployment, personal bankruptcy filings, business bankruptcy filings, the interest rate environment, residential vacancy rates, housing inventory for sale, and the competitive environment. Lower unemployment lowers credit risk and the necessary allowance for loan losses, while higher unemployment increases credit risk. Higher bankruptcy filings indicate heightened credit risk and increase the allowance for loan losses, while lower bankruptcy filings have a beneficial impact on credit risk. The interest rate environment impacts variable rate loans. As interest rates increase, the payment on variable rate loans increases, increasing credit risk. Residential vacancy rates and housing inventory for sale impact the Company’s residential construction customers and the consumer real estate market. Higher levels increase credit risk. Higher competition for loans increases credit risk, while lower competition decreases credit risk.

Economic indicators that improved from December 31, 2016 were lower unemployment, lower personal bankruptcies and lower housing inventory for sale in the Company’s market area. Improved economic indicators result in a lower requirement for the allowance for loan losses. Economic indicators that negatively impacted credit risk included elevated business bankruptcies and increases in the interest rate environment, when data at December 31, 2017 are compared with data at December 31, 2016. Residential vacancy rates resulted in a slightly larger allowance, and the competitive environment remained at a similar level to that at December 31, 2016.

The Company considers other factors that impact credit risk, including the legal and regulatory environments, changes to lending policies and loan review, and management’s experience. Each of the factors remained at similar levels to December 31, 2016.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.34% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, a decrease from 0.39% at December 31, 2016. Accruing loans past due 90 days or more were 0.01% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, the same level as December 31, 2016. Nonaccrual loans decreased to 0.41% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, from 0.90% at December 31, 2016. Decreases in past due and nonaccrual loans reduce the required level of the allowance for loan losses, while increases in past due and nonaccrual loans increase the required level of the allowance for loan losses.

Table of Contents

Loans rated “special mention” and “classified” (together, “criticized assets”) indicate heightened credit risk. Higher levels of criticized assets increase the required level of the allowance for collectively-evaluated loans, while lower levels of criticized assets reduce the required level of the allowance for collectively-evaluated loans. Loans rated special mention receive a 50% greater allocation for qualitative risk factors, and loans rated classified receive a 100% greater allocation for qualitative risk factors. A classified loss rate is also applied to classified loans, calculated as net charge offs divided by classified loans.

Collectively evaluated loans rated “special mention” were $3,361 at December 31, 2017, down from $13,519 at December 31, 2016. Collectively evaluated loans rated classified were $1,691 at December 31, 2017, down from $3,052 at December 31, 2016.

Levels of high risk loans are considered in the determination of the level of the allowance for loan loss. High risk loans are defined by the Company as loans secured by junior liens, interest-only loans and loans with a high loan-to-value ratio. A decrease in the level of high risk loans within a class decreases the required allocation for the loan class, and an increase in the level of high risk loans within a class increases the required allocation for the loan class. Total high risk loans fell by $6,081 or 3.76% from the level at December 31, 2016, resulting in a decreased allocation.

The calculation of the appropriate level for the allowance for loan losses incorporates analysis of multiple factors and requires management’s prudent and informed judgment. The ratio of the allowance for loan losses to total loans, net of unearned income and deferred fees and costs at December 30, 2017 is 1.19%, a decrease from 1.28% at December 31, 2016. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.18%, compared with 1.30% at December 31, 2016. Improvements from December 31, 2016 in the charge-off rate, nonaccrual loans, criticized loans, unemployment, personal bankruptcies and housing inventory decreased the required level of the allowance for loan losses, slightly offset by worsening in business bankruptcies, residential vacancy and the impact of the interest rate environment. Based on analysis of historical indicators, asset quality and economic factors, management believes the level of allowance for loan losses is reasonable for the credit risk in the loan portfolio.

Quarterly Results of Operations

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2017, 2016 and 2015:

	2017			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income Statement Data:				
Interest income	**$10,238**	**$ 10,295**	**$ 10,301**	**$ 10,426**
Interest expense	**1,028**	**1,048**	**1,021**	**1,028**
Net interest income	**9,210**	**9,247**	**9,280**	**9,398**
Provision for loan losses	**59**	**464**	**201**	**(567)**

Noninterest income	**2,504**	**2,455**	**2,598**	**2,822**
Noninterest expense	**6,937**	**6,698**	**6,745**	**6,592**
Income taxes	**1,069**	**970**	**1,147**	**3,107**
Net income	**$ 3,649**	**$ 3,570**	**$ 3,785**	**$ 3,088**
Per Share Data:				
Basic net income per common share	**$ 0.52**	**$ 0.51**	**$ 0.54**	**$ 0.46**
Fully diluted net income per common share	**0.52**	**0.51**	**0.54**	**0.46**
Cash dividends per common share	**---**	**0.56**	**---**	**0.61**
Book value per common share	**26.30**	**26.49**	**26.97**	**26.57**

Table of Contents

	2016 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$10,484	$ 10,292	$ 10,157	$ 9,997
Interest expense	1,068	1,063	1,019	1,016
Net interest income	9,416	9,229	9,138	8,981
Provision for loan losses	203	654	291	502
Noninterest income	2,341	2,618	2,481	2,492
Noninterest expense	6,684	6,238	6,620	6,610
Income taxes	1,091	1,090	880	891
Net income	$3,779	$ 3,865	$ 3,828	$ 3,470
Per Share Data:				
Basic net income per common share	$0.54	$ 0.56	$ 0.55	$ 0.51
Fully diluted net income per common share	0.54	0.56	0.55	0.51
Cash dividends per common share	---	0.55	---	0.61
Book value per common share	25.76	25.86	26.47	25.62

	2015 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$10,794	$ 10,724	$ 10,760	$ 10,636
Interest expense	1,087	1,051	1,009	1,036
Net interest income	9,707	9,673	9,751	9,600
Provision for loan losses	201	355	178	1,275
Noninterest income	2,258	2,471	2,289	2,468
Noninterest expense	6,687	6,369	6,322	6,257
Income taxes	1,111	1,310	1,341	978
Net income	$3,966	$ 4,110	$ 4,199	$ 3,558
Per Share Data:				
Basic net income per common share	$0.57	$ 0.59	$ 0.60	$ 0.52
Fully diluted net income per common share	0.57	0.59	0.60	0.52
Cash dividends per common share	---	0.53	---	0.61
Book value per common share	24.85	24.10	25.07	25.62

Balance Sheet

On December 31, 2017, the Company had total assets of $1,256,757, an increase of $22,815 or 1.85%, over the total of $1,233,942 on December 31, 2016. For 2017, the growth in assets was entirely internally generated and was not the result of acquisitions. Total assets at December 31, 2016 were up by $30,423, or 2.53%, over the total at December 31, 2015.

Loans

The Company’s loan categorization reflects its approach to loan portfolio management and includes six groups. Real estate construction loans include construction loans for residential and commercial properties, as well as land. Consumer real estate loans include conventional and junior lien mortgages, equity lines and investor-owned residential real estate. Commercial real estate loans are comprised of owner-occupied and leased nonfarm, nonresidential properties, multi-family residence loans and farmland. Commercial non real estate loans include agricultural loans, operating capital lines and loans secured by capital assets. Public sector and IDA loans are extended to municipalities. Consumer non real estate loans include automobile loans, personal loans, credit cards and consumer overdrafts.

Table of Contents

A. Types of Loans

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Real estate construction	**$34,694**	$36,345	$48,251	$45,562	$45,925
Consumer real estate	**166,965**	157,718	143,504	147,039	145,499
Commercial real estate	**340,414**	336,457	309,378	310,762	311,266
Commercial non real estate	**40,518**	39,024	37,571	33,413	31,262
Public sector and IDA	**51,443**	45,474	51,335	41,361	34,220
Consumer non real estate	**34,648**	33,528	29,845	28,182	28,423
Total loans	**$668,682**	$648,546	$619,884	$606,319	$596,595
Less unearned income and deferred fees	**(613)**	(794)	(876)	(853)	(905)
Total loans, net of unearned income and deferred fees and costs	**$668,069**	$647,752	$619,008	$605,466	$595,690
Less allowance for loans losses	**(7,925)**	(8,300)	(8,297)	(8,263)	(8,227)
Total loans, net	**$660,144**	$639,452	$610,711	$597,203	$587,463

B. Maturities and Interest Rate Sensitivities

The following table presents maturities and interest rate sensitivities for commercial non real estate, commercial real estate and real estate construction loans.

	December 31, 2017			
	< 1 Year	**1 – 5 Years**	**After 5 Years**	**Total**
Commercial non real estate	**$26,301**	**$14,058**	**$159**	**$40,518**
Commercial real estate	**75,047**	**209,177**	**56,190**	**340,414**
Real estate construction	**24,629**	**9,880**	**185**	**34,694**
Total	**124,977**	**233,115**	**56,534**	**415,626**
Less loans with predetermined interest rates	**(17,360)**	**(31,037)**	**(7,974)**	**(56,371)**
Loans with adjustable rates	**$108,617**	**$202,078**	**$48,560**	**$359,255**

Table of Contents

C. Risk Elements

The following table presents aggregate amounts for nonaccrual loans, restructured loans in nonaccrual, other real estate owned net, and accruing loans which are contractually past due ninety days or more as to interest or principal payments, and accruing restructured loans.

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Nonaccrual loans:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**6**	256	14	164	198
Commercial real estate	**---**	698	1,146	3,087	5,383
Commercial non real estate	**---**	217	883	748	128
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	---	---	---	23
Total nonaccrual loans	**$6**	$1,168	$2,043	$3,999	$5,732
Restructured loans (TDR Loans) in nonaccrual					
Real estate construction	**$---**	$270	$718	$---	$---
Consumer real estate	**145**	---	---	---	201
Commercial real estate	**2,602**	4,390	3,921	5,288	651
Commercial non real estate	**15**	24	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**1**	3	---	---	---
Total restructured loans in nonaccrual	**$2,763**	$4,687	$4,639	$5,288	$852
Total nonperforming loans	**$2,769**	$5,855	$6,682	$9,287	$6,584
Other real estate owned, net	**2,817**	3,156	4,165	4,744	4,712
Total nonperforming assets	**$5,586**	$9,011	$10,847	$14,031	$11,296
Accruing loans past due 90 days or more:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**11**	42	145	82	128
Commercial real estate	**---**	---	---	102	---
Commercial non real estate	**---**	---	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**40**	21	11	23	62
Total accruing loans past due 90 days or more	**$51**	$63	$156	$207	$190
Accruing restructured loans:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**947**	877	962	819	579
Commercial real estate	**2,948**	2,892	7,645	5,192	5,552
Commercial non real estate	**1,214**	---	207	29	60
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**25**	---	---	---	---
Total accruing restructured loans	**$5,134**	$3,769	$8,814	$6,040	$6,191

32

Table of Contents

Loan loss and other indicators related to asset quality are presented in the Loan Loss Data table.

Loan Loss Data Table

	2017		2016		2015	
Provision for loan losses	**$157**		$1,650		$2,009	
Net charge-offs to average net loans	**0.08**	**%**	0.26	%	0.32	%
Allowance for loan losses to loans, net of unearned income and deferred fees	**1.19**	**%**	1.28	%	1.34	%
Allowance for loan losses to nonperforming loans	**286.20**	**%**	141.76	%	124.17	%
Allowance for loan losses to nonperforming assets	**141.87**	**%**	92.11	%	76.49	%
Nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	**0.83**	**%**	1.38	%	1.74	%
Nonaccrual loans	**$6**		$1,168		$2,043	
Restructured loans in nonaccrual status	**2,763**		4,687		4,639	
Other real estate owned, net	**2,817**		3,156		4,165	
Total nonperforming assets	**$5,586**		$9,011		$10,847	
Accruing loans past due 90 days or more	**$51**		$63		$156	

Nonperforming loans include nonaccrual loans and restructured loans (“troubled debt restructurings” or “TDR loans”) in nonaccrual status, but do not include accruing loans 90 days or more past due or accruing restructured loans. Troubled debt restructurings are discussed in detail under the section titled “D. Modifications and Troubled Debt Restructurings (TDR Loans)” below. Impaired loans, or loans for which management does not expect to collect at the original loan terms, but which may or may not be nonperforming, are presented in Note 5 of Notes to Consolidated Financial Statements.

Total impaired loans at December 31, 2017 were $11,924, of which $2,763 were in nonaccrual status. Impaired loans at December 31, 2016 and 2015 were $9,173 and $15,346, of which $5,404 and $6,532 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans improved from 141.76% in 2016 to 286.20% in 2017. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

Table of Contents

D. Modifications and Troubled Debt Restructurings ("TDRs")

In the ordinary course of business the Company modifies loan terms on a case-by-case basis, including both consumer and commercial loans, for a variety of reasons. Modifications to consumer loans generally involve short-term deferrals to accommodate specific, temporary circumstances. The Company may grant extensions to borrowers who have demonstrated a willingness and ability to repay their loan but who are experiencing consequences of a specific unforeseen temporary hardship.

An extension defers monthly payments and requires a balloon payment at the original contractual maturity. If the temporary event is not expected to impact a borrower's ability to repay the debt, and if the Company expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay at contractual maturity, the modification is not designated a TDR.

Modifications to commercial loans may include, but are not limited to, changes in interest rate, maturity, amortization and financial covenants. In the original underwriting, loan terms are established that represent the then-current and projected financial condition of the borrower. If the modified terms are consistent with competitive market conditions and representative of terms the borrower could otherwise obtain in the open market, the modified loan is not categorized as a TDR.

The Company codes modifications to assist in identifying troubled debt restructurings. The majority of modifications were granted for competitive reasons and did not constitute troubled debt restructurings. A description of modifications that did not result in troubled debt restructurings follows:

Modifications Made During the 12 Months Ended December 31, 2017

to Borrowers Not Experiencing Financial Difficulty

Modification	Number of Loans Modified	Total Amount Modified
Rate reductions for competitive purposes	**29**	**$ 11,783**
Payment extensions for less than 3 months	**126**	**2,693**
Maturity date extensions of more than 3 months and up to 6 months	**182**	**29,253**
Maturity date extensions of more than 6 months and up to 12 months	**316**	**14,675**
Maturity date extensions of more than 12 months	**7**	**3,474**
Advances on non-revolving loans or recapitalization	**12**	**4,603**
Change in amortization term or method	**42**	**4,884**
Renewal of expired Home Equity Line of Credit loans to additional 10 years	**19**	**448**
Renewal of single-payment notes	**240**	**5,044**
Total modifications that do not constitute TDRs	**973**	**$ 76,857**

Modifications Made During the 12 Months Ended December 31, 2016

to Borrowers Not Experiencing Financial Difficulty

Modification	Number of Loans Modified	Total Amount Modified
Rate reductions for competitive purposes	73	$ 34,080
Payment extensions for less than 3 months	142	2,475
Maturity date extensions of more than 3 months and up to 6 months	219	20,781
Maturity date extensions of more than 6 months and up to 12 months	274	13,277
Maturity date extensions of more than 12 months	17	3,073
Advances on non-revolving loans or recapitalization	2	177
Change in amortization term or method	26	2,292
Renewal of expired Home Equity Line of Credit loans to additional 10 years	19	678
Renewal of single-payment notes	244	4,722
Total modifications that do not constitute TDRs	1,016	$ 81,555

Table of Contents

Modifications Made During the 12 Months Ended December 31, 2015

to Borrowers Not Experiencing Financial Difficulty

Modification	Number of Loans Modified	Total Amount Modified
Rate reductions for competitive purposes	70	$ 38,417
Payment extensions for less than 3 months	115	2,486
Maturity date extensions of more than 3 months and up to 6 months	260	30,257
Maturity date extensions of more than 6 months and up to 12 months	260	15,613
Maturity date extensions of more than 12 months	6	330
Advances on non-revolving loans or recapitalization	2	566
Change in amortization term or method	20	2,580
Renewal of expired Home Equity Line of Credit loans to additional 10 years	25	597
Renewal of single-payment notes	235	4,144
Total modifications that do not constitute TDRs	993	$ 94,990

Modifications in which the borrower is experiencing financial difficulty and for which the Company makes a concession to the original contractual loan terms are designated troubled debt restructurings.

Modifications of loan terms to borrowers experiencing financial difficulty are made in an attempt to protect as much of the Company’s investment in the loan as possible. The determination of whether a modification should be accounted for as a TDR requires significant judgment after consideration of all facts and circumstances surrounding the transaction.

Assuming all other TDR criteria are met, the Company considers one or a combination of the following concessions to the loan terms to indicate TDR status: a reduction of the stated interest rate, an extension of the maturity date at an interest rate lower than the current market rate for a new loan with a similar term and similar risk, or forgiveness of principal or accrued interest.

The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure. All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans with an impairment loss or that do not demonstrate current payments for at least six months are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

Table of Contents

The Company had $7,897 in TDRs as of December 31, 2017 and $8,456 as of December 31, 2016. Accruing TDR loans amounted to $5,134 at December 31, 2017 compared to $3,769 at December 31, 2016.

Restructuring generally results in loans with either lower payments or an extended maturity beyond that originally required, and are expected to have a lower risk of loss due to nonperformance than loans classified as nonperforming. In 2017, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $1,387 and that have total principal balances of $1,369 as of December 31, 2017. Some of the Company's restructured loans defaulted during the twelve months ended December 31, 2017. The Company defines default as a delay in one payment of more than 90 days or foreclosure after the date of restructuring. All of the restructured loans that defaulted had been modified more than twelve months prior to default.

In 2016, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $3,042 and that had total principal balances of $2,761 as of December 31, 2016. All of the restructured loans that defaulted in 2016 had been modified more than twelve months prior to default.

Please refer to Note 5 for information on the effect of default on the allowance for loan losses.

	TDR Delinquency Status as of December 31, 2017				
	Total TDR Loans	**Current**	**Accruing 30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Real estate construction	**$ ---**	**$ ---**	**$ ---**	**$ ---**	**$ ---**
Consumer real estate	**1,092**	**773**	**174**	**---**	**145**
Commercial real estate	**5,550**	**2,948**	**---**	**---**	**2,602**
Commercial non real estate	**1,229**	**1,214**	**---**	**---**	**15**
Public sector and IDA	**---**	**---**	**---**	**---**	**---**
Consumer non real estate	**26**	**25**	**---**	**---**	**1**
Total TDR Loans	**$7,897**	**$ 4,960**	**$ 174**	**$ ---**	**$ 2,763**

	TDR Delinquency Status as of December 31, 2016				
	Total TDR Loans	**Current**	**Accruing 30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Real estate construction	$270	$ ---	$ ---	$ ---	$ 270
Consumer real estate	877	717	160	---	---
Commercial real estate	7,282	2,892	---	---	4,390
Commercial non real estate	24	---	---	---	24

Public sector and IDA	---	---	---	---	---
Consumer non real estate	3	---	---	---	3
Total TDR Loans	$8,456	$ 3,609	$ 160	$ ---	$ 4,687

TDR Delinquency Status as of December 31, 2015

	Total TDR Loans	Current	Accruing 30-89 Days Past Due	90+ Days Past Due	Nonaccrual
Real estate construction	$718	$ ---	$ ---	$ ---	$ 718
Consumer real estate	962	784	178	---	---
Commercial real estate	11,566	7,645	---	---	3,921
Commercial non real estate	207	207	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non real estate	---	---	---	---	---
Total TDR Loans	$13,453	$ 8,636	$ 178	$ ---	$ 4,639

Table of Contents

Summary of Loan Loss Experience

A. Analysis of the Allowance for Loan Losses

The following tabulation shows average loan balances at the end of each period; changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category; and additions to the allowance which have been charged to operating expense:

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Average loans, net of unearned income and deferred fees and costs	**$653,364**	$621,654	$619,745	$592,944	$585,991
Allowance for loan losses at beginning of year	**8,300**	8,297	8,263	8,227	8,349
Charge-offs:					
Real estate construction	**---**	29	---	2	184
Consumer real estate	**146**	133	205	222	256
Commercial real estate	**139**	488	1,114	1,201	64
Commercial non real estate	**82**	883	490	89	968
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**452**	273	311	346	348
Total loans charged off	**819**	1,806	2,120	1,860	1,820
Recoveries:					
Real estate construction	**---**	---	---	---	44
Consumer real estate	**1**	2	2	---	1
Commercial real estate	**131**	83	49	50	25
Commercial non real estate	**23**	10	1	132	18
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**132**	64	93	73	79
Total recoveries	**287**	159	145	255	167
Net loans charged off	**532**	1,647	1,975	1,605	1,653
Provision charged to operations	**157**	1,650	2,009	1,641	1,531
Allowance for loan losses at end of year	**$7,925**	$8,300	$8,297	$8,263	$8,227
Net charge-offs to average loans net of unearned income and deferred fees and costs	**0.08** **%**	0.26 %	0.32 %	0.27 %	0.28 %

The Company charges off commercial real estate loans at the time that a loss is confirmed. When delinquency status or other information indicates that the borrower will not repay the loan, the Company considers collateral value based upon a current appraisal or internal evaluation. Any loan amount in excess of collateral value is charged off and the collateral is taken into other real estate owned.

Management analyzes many factors to determine the appropriate level for the allowance for loan losses and resultant provision expense, including the historical loss rate, the quality of the loan portfolio as determined by management, diversification as to type of loans in the portfolio, internal policies and economic factors. Management considers net

charge-offs over the most recent eight quarters to determine the historical loss rate to be applied to the calculation. The historical loss rate contributes significantly to the required level for the allowance for loan losses.

Table of Contents

B. Allocation of the Allowance for Loan Losses

The allowance for loan losses has been allocated according to the amount deemed necessary to provide for anticipated losses within the categories of loans for the years indicated as follows:

	December 31, 2017		**2016**		**2015**		**2014**		**2013**	
	Allowance Amount	**Percent of Loans in Each Category to Total Loans[1]**	**Allowance Amount**	**Percent of Loans in Each Category to Total Loans[1]**	**Allowance Amount**	**Percent of Loans in Each Category to Total Loans[1]**	**Allowance Amount**	**Percent of Loans in Each Category to Total Loans[1]**	**Allowance Amount**	**Percent of Loans in Each Category to Total Loans[1]**
Real estate construction	**$337**	**5.19 %**	$438	5.60 %	$576	7.78 %	$612	7.52 %	$863	7.70 %
Consumer real estate	**2,027**	**24.97 %**	1,830	24.32 %	1,866	23.15 %	1,662	24.25 %	1,697	24.39 %
Commercial real estate	**3,044**	**50.91 %**	3,738	51.88 %	4,109	49.92 %	3,537	51.25 %	3,685	52.17 %
Commercial non real estate	**1,072**	**6.06 %**	1,063	6.02 %	655	6.06 %	1,475	5.51 %	989	5.24 %
Public sector and IDA	**419**	**7.69 %**	330	7.01 %	436	8.28 %	327	6.82 %	132	5.74 %
Consumer non real estate	**707**	**5.18 %**	644	5.17 %	627	4.81 %	602	4.65 %	576	4.76 %
Unallocated	**319**		257		28		48		285	
	$7,925	**100.00 %**	$8,300	100.00 %	$8,297	100.00 %	$8,263	100.00 %	$8,227	100.00 %

(1) Loans are presented on a gross basis.

An analysis of the allowance for loan losses by impairment basis follows:

	December 31,		
	2017	**2016**	**2015**
Impaired loans[1]	**$11,924**	$9,173	$15,346
Allowance related to impaired loans[1]	**177**	26	45
Allowance to impaired loans[1]	**1.48 %**	0.27 %	0.29 %

Non-impaired loans[1]	**656,758**	639,373	604,538
Allowance related to non-impaired loans[1]	**7,748**	8,274	8,252
Allowance to non-impaired loans[1]	**1.18 %**	1.29 %	1.37 %
Total gross loans	**668,682**	648,546	619,884
Less: unearned income and deferred fees and costs	**(613)**	(794)	(876)
Loans, net of unearned income and deferred fees and costs	**668,069**	647,752	619,008
Allowance for loan losses, total	**7,925**	8,300	8,297
Allowance as a percentage of loans, net of unearned income and deferred fees and costs	**1.19 %**	1.28 %	1.34 %

(1) Loans are presented on a gross basis.

Table of Contents

Individually-evaluated impaired loans are valued using the appraised value of the underlying collateral or the present value of cash flows for each loan. Valuation procedures for impaired loans resulted in a required reserve for impaired loans of $177 at December 31, 2017, $26 at December 31, 2016 and $45 at December 31, 2015. The amount of the individual impaired loan balance that exceeds the fair value is accrued in the allowance for loan losses.

Management's analysis of the loan portfolio and pertinent economic conditions resulted in a determination of the allowance for loan losses for collectively-evaluated loans of $7,748 or 1.18% at December 31, 2017, $8,275 or 1.30% at December 31, 2016, and $8,252 or 1.37% at December 31, 2015. The allowance for collectively-evaluated loans is determined by applying historical charge-off percentages, as well as additional accruals for internal and external credit risk factors to groups of collectively-evaluated loans. The ratio decreased from 2016 to 2017 due to a decreased charge-off ratio, down from 0.26% for the twelve months ended December 31, 2016 to 0.08% for the year ended December 31, 2017. Also contributing to the reduced allowance requirement were improved asset quality indicators, lower levels of high risk loans and favorable economic indicators. The ratio decreased from 2015 to 2016 due to decreases in net charge-offs. When compared with 2015, the level of the allowance for loan losses for 2016 also benefitted from improvements in asset quality, high risk loans and economic indicators.

The unallocated portion of the reserve was $319 at December 31, 2017, $257 at December 31, 2016 and $28 at December 31, 2015. The unallocated portion of the reserve is the amount that exceeds the calculated requirement for the allowance for loan losses. The Company's policy permits an unallocated reserve of up to 5% in excess of the required level for the allowance for loan losses.

The total calculated allowance for loan losses of $7,925 at December 31, 2017, $8,300 as of December 31, 2016 and $8,297 as of December 31, 2015 indicated provision charges for loan losses of $157 for the twelve months ended December 31, 2017, $1,650 for the twelve months ended December 31, 2016 and $2,009 for the twelve months ended December 31, 2015. Please refer to the discussion under "Provision and Allowance for Loan Losses" for additional information on the determination of the allowance for loan loss.

Securities

The fair value of securities available for sale was $331,387, an increase of $27,105 or 8.91% from December 31, 2016. The amortized cost of securities held to maturity was $127,164 at December 31, 2017 and $134,957 at December 31, 2016, a decrease of $7,793 or 5.77%.

Additional information about securities available for sale and securities held to maturity can be found in Note 3 of the Notes to Consolidated Financial Statements.

The securities portfolio is subject to the volatility and risk in the financial markets. The risk in financial markets affects the Company in the same way that it affects other institutional and individual investors. The Company's investment portfolio includes corporate bonds. If, because of economic hardship, the corporate issuers were to default, there could be a delay in the payment of interest, or there could be a loss of principal and accrued interest. To date, there have been no defaults in any of the corporate bonds held in the portfolio. The Company's investment portfolio also contains a large percentage of municipal bonds. If economic forces reduce the ability of states and municipalities to make scheduled principal and interest payments on their outstanding indebtedness, or if their income from taxes and other sources declines significantly, states and municipalities could default on their bond obligations. There have

been no defaults among the municipal bonds in the Company’s investment portfolio. The fair value of our bond portfolio is affected by interest rates. The fair value of available for sale securities is reflected on the Company's balance sheet, while held to maturity securities are reported at amortized cost.

In making investment decisions, management follows internal policy guidelines that help to limit risk by specifying parameters for both security quality and industry and geographic concentrations. Management regularly monitors the quality of the investment portfolio and tracks changes in financial markets. The value of individual securities will be written down if a decline in fair value is considered to be other than temporary, given the totality of the circumstances.

Table of Contents

Maturities and Associated Yields

The following table presents the maturities for securities available for sale and held to maturity at their carrying values as of December 31, 2017 and weighted average yield for each range of maturities.

$ in thousands, except percent data	**Maturities and Yields December 31, 2017**					
	< 1 Year	**1-5 Years**	**5-10 Years**	**> 10 Years**	**None**	**Total**
Available for Sale:						
U.S. Government agencies	**$32,026**	**$185,782**	**$66,677**	**$23,234**	**$---**	**$307,719**
	1.10 %	**1.49 %**	**2.39 %**	**3.33 %**	**---**	**1.78 %**
Mortgage-backed securities	**$10**	**$71**	**$162**	**$416**	**$---**	**$659**
	4.84 %	**5.00 %**	**5.62 %**	**5.47 %**	**---**	**5.44 %**
States and political subdivision – nontaxable (1)	**$1,202**	**$2,145**	**$3,670**	**$9,817**	**$---**	**$16,834**
	5.75 %	**5.84 %**	**5.39 %**	**4.13 %**	**---**	**4.73 %**
Corporate	**$---**	**$1,007**	**$---**	**$5,168**	**$---**	**$6,175**
	---	**2.48 %**	**---**	**4.15 %**	**---**	**3.88 %**
Other securities	**$---**	**$---**	**$---**	**$---**	**$---**	**$---**
	---	**---**	**---**	**---**	**---**	**---**
Total	**$33,238**	**$189,005**	**$70,509**	**$38,635**	**$---**	**$331,387**
	1.27 %	**1.55 %**	**2.55 %**	**3.67 %**	**---**	**1.98 %**
Restricted stock:						
Restricted stock	**$---**	**$---**	**$---**	**$---**	**$1,200**	**$1,200**
	---	**---**	**---**	**---**	**4.92 %**	**4.92 %**
Held to Maturity:						
U.S. Government agencies	**$---**	**$2,999**	**$---**	**$935**	**$---**	**$3,934**
	---	**3.75 %**	**---**	**3.54 %**	**---**	**3.70 %**
Mortgage-backed securities	**$---**	**$---**	**$117**	**$92**	**$---**	**$209**
	---	**---**	**5.13 %**	**6.08 %**	**---**	**5.55 %**
States and political subdivision – nontaxable (1)	**$11,906**	**$20,422**	**$25,125**	**$64,586**	**$---**	**$122,039**
	6.53 %	**6.35 %**	**5.05 %**	**4.99 %**	**---**	**5.38 %**
Corporate	**$---**	**$982**	**$---**	**$---**	**$---**	**$982**
	---	**2.40 %**	**---**	**---**	**---**	**2.40 %**
Total	**$11,906**	**$24,403**	**$25,242**	**$65,613**	**$---**	**$127,164**
	6.53 %	**5.87 %**	**5.05 %**	**4.97 %**	**---**	**5.31 %**

(1) Rates shown represent weighted average yield on a fully taxable basis.

The majority of mortgage-backed securities and collateralized mortgage obligations held at December 31, 2017 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Federal Financial Institution Examination Council's (FFIEC) high risk mortgage security test. These tests address possible fluctuations in the average life and variances caused by the change in rate times the change in volume that have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each. Except for U.S. Government securities, the Company has no securities with any issuer that exceeds 10% of stockholders' equity.

Deposits

Total deposits increased by $16,292 or 1.56%, from $1,043,442 at December 31, 2016 to $1,059,734 at December 31, 2017. Total deposits grew $24,583, or 2.41%, from $1,018,859 at December 31, 2015 to December 31, 2016. A portion of the increase in both 2017 and 2016 is attributable to a higher level of municipal deposits. The increases in total deposits for 2017 and 2016 were internally generated and not the result of acquisitions.

Table of Contents

A. Average Amounts of Deposits and Average Rates Paid

Average amounts and average rates paid on deposit categories are presented below:

	Year Ended December 31,								
	2017			2016			2015		
	Average Amounts	Average Rates Paid		Average Amounts	Average Rates Paid		Average Amounts	Average Rates Paid	
Noninterest-bearing demand deposits	**$178,708**	**---**		$170,344	---		$159,829	---	
Interest-bearing demand deposits	**598,661**	**0.56**	**%**	567,971	0.55	%	525,864	0.55	%
Savings deposits	**140,997**	**0.17**	**%**	134,982	0.23	%	127,534	0.32	%
Time deposits	**120,220**	**0.45**	**%**	140,490	0.50	%	163,370	0.53	%
Average total deposits	**$1,038,586**	**0.40**	**%**	$1,013,787	0.41	%	$976,597	0.43	%

B. Time Deposits of $250 or More

The following table sets forth time certificates of deposit and other time deposits of $250 or more:

	December 31, 2017				
	3 Months or Less	Over 3 Months Through 6 Months	Over 6 Months Through 12 Months	Over 12 Months	Total
Total time deposits of $250 or more	**$1,587**	**$ 1,215**	**$ 6,565**	**$ 4,666**	**$14,033**

Derivatives and Market Risk Exposures

The Company is not a party to derivative financial instruments with off-balance sheet risks such as futures, forwards, swaps, and options. The Company is a party to financial instruments with off-balance sheet risks such as commitments to extend credit, standby letters of credit, and recourse obligations in the normal course of business to meet the financing needs of its customers. See Note 14, of Notes to Consolidated Financial Statements for additional information relating to financial instruments with off-balance sheet risk. Management does not plan any future involvement in high risk derivative products. The Company has investments in mortgage-backed securities,

principally GNMA's and FNMA's, with a fair value of approximately $889. See Note 3 of Notes to Consolidated Financial Statements for additional information relating to securities.

The Company's securities and loans are subject to credit and interest rate risk, and its deposits are subject to interest rate risk. Management considers credit risk when a loan is granted and monitors credit risk after the loan is granted. The Company maintains an allowance for loan losses to absorb losses in the collection of its loans. See Note 5 of Notes to Consolidated Financial Statements for information relating to the allowance for loan losses. See Note 15 of Notes to Consolidated Financial Statements for information relating to concentrations of credit risk. The Company has an asset/liability program to manage its interest rate risk. This program provides management with information related to the rate sensitivity of certain assets and liabilities and the effect of changing rates on profitability and capital accounts.

The effects of changing interest rates are primarily managed through adjustments to the loan portfolio and deposit base, to the extent competitive factors allow. The investment portfolio is generally longer term. Adjustments for asset and liability management are made when securities are called or mature and funds are subsequently reinvested. Securities may be sold for reasons related to credit quality or regulatory limitations, and in limited circumstances, securities available for sale have been disposed of for interest rate risk management. No trading activity for this purpose is planned in the foreseeable future, though it does remain an option.

While the asset/liability planning program is designed to protect the Company over the long term, it does not provide near-term protection from interest rate shocks, as interest rate sensitive assets and liabilities do not by their nature move up or down in tandem in response to changes in the overall rate environment. The Company's profitability in the near term may be temporarily negatively affected in a period of rapidly rising or rapidly falling rates, because it takes some time for the Company to change its rates to adjust to a new interest rate environment. See Note 16 of Notes to Consolidated Financial Statements for information relating to fair value of financial instruments and comments concerning interest rate sensitivity.

Table of Contents

Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At December 31, 2017, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

Liquidity from securities is restricted by accounting and business considerations. The securities portfolio is segregated into available-for-sale and held-to-maturity. The Company considers only securities designated available-for-sale for typical liquidity needs. Further, portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased/decreased liquidity from public funds deposits or discount window borrowings results in increased/decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and unpledged available-for-sale securities accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to use purchased deposits and the Federal Reserve discount window. At December 31, 2017, the Company is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At December 31, 2017, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At December 31, 2017, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At December 31, 2017, the loan to deposit ratio was 63.04%, slightly below policy levels. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

In the normal course of business, we enter into certain contractual obligations, including obligations to make future payments on lease arrangements, contractual commitments with depositors, and service contracts. The table below presents our significant contractual obligations as of December 31, 2017, except for pension and other postretirement benefit plans, which are included in Note 8, "Employee Benefit Plans," to the Consolidated Financial Statements in this Form 10-K.

Payments Due by Period

	Total	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
Time deposits	**$114,884**	**$76,285**	**$32,370**	**$6,180**	**$ 49**
Purchase obligations [1]	**7,106**	**3,089**	**3,517**	**500**	**---**
Operating leases	**779**	**292**	**289**	**68**	**130**
Total	**$122,769**	**$79,666**	**$36,176**	**$6,748**	**$ 179**

(1) Includes contracts with a minimum annual payment of $100

As of December 31, 2017, the Company was not aware of any other known trends, events or uncertainties that have or are reasonably likely to have a material impact on our liquidity. As of December 31, 2017, the Company has no material commitments for long-term debt or for capital expenditures.

Recent Accounting Pronouncements

See Note 1 of Notes to Consolidated Financial Statements for information relating to recent accounting pronouncements.

Capital Resources

Total stockholders' equity at December 31, 2017 was $184,896, an increase of $6,633, or 3.72%, from the $178,263 at December 31, 2016. The largest component of 2017 stockholders' equity was retained earnings of $185,893, which included net income of $14,092, offset by dividends of $8,141. Total stockholders' equity increased by $6,149 or 3.57%, from $172,114 on December 31, 2015 to $178,263 on December 31, 2016.

Table of Contents

Risk based capital ratios are shown in the following tables.

	Ratios at December 31, 2017		**Regulatory Capital Minimum Ratios**		**Regulatory Capital Minimum Ratios with Capital Conservation Buffer**	
Common Equity Tier I Capital Ratio	**23.562**	**%**	**4.500**	**%**	**5.750**	**%**
Tier I Capital Ratio	**23.562**	**%**	**6.000**	**%**	**7.250**	**%**
Total Capital Ratio	**24.542**	**%**	**8.000**	**%**	**9.250**	**%**
Leverage Ratio	**15.424**	**%**	**4.000**	**%**	**4.000**	**%**

	Ratios at December 31, 2016		**Regulatory Capital Minimum Ratios**		**Regulatory Capital Minimum Ratios with Capital Conservation Buffer**	
Common Equity Tier I Capital Ratio	25.420	%	4.500	%	5.125	%
Tier I Capital Ratio	25.420	%	6.000	%	6.625	%
Total Capital Ratio	26.575	%	8.000	%	8.625	%
Leverage Ratio	15.121	%	4.000	%	4.000	%

Risk-based capital ratios are calculated in compliance with Federal Reserve rules based on Basel III capital requirements. The Company’s ratios are well above the required minimums at December 31, 2017 and December 31, 2016.

Banks and bank holding companies are subject to an additional capital conservation buffer in order to make capital distributions or discretionary bonus payments. The implementation period for the capital conservation buffer began in 2016 and will be fully phased in January 1, 2019, with .625% added each year and a final buffer of 2.5% in excess of regulatory capital minimum ratios.

Off-Balance Sheet Arrangements

The Company’s off-balance sheet arrangements at December 31, 2017 are detailed in the table below.

	Payments Due by Period				
	Total	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**More Than 5 Years**

Commitments to extend credit	**$161,222**	**$161,222**	**$ ---**	**$ ---**	**$ ---**
Standby letters of credit	**16,351**	**16,351**	**---**	**---**	**---**
Mortgage loans with potential recourse	**14,130**	**14,130**	**---**	**---**	**---**
Operating leases	**779**	**292**	**289**	**68**	**130**
Total	**$192,482**	**$191,995**	**$ 289**	**$ 68**	**$ 130**

In the normal course of business the Company's banking affiliate extends lines of credit to its customers. Amounts drawn upon these lines vary at any given time depending on the business needs of the customers.

Standby letters of credit are also issued to the bank's customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation. Revenue from these letters was approximately $57 in 2017.

While it would be possible for customers to fully draw on approved lines of credit and for beneficiaries to call all letters of credit, historically this has not occurred. In the event of a sudden and substantial draw on these lines, the Company has its own lines of credit from which it can draw funds. A sale of loans or investments would also be an option.

The Company sells mortgages on the secondary market subject to recourse agreements. The mortgages originated must meet strict underwriting and documentation requirements for the sale to be completed. The Company estimates a potential loss reserve for recourse provisions. The amount is not material as of December 31, 2017. To date, no recourse provisions have been invoked.

Operating leases are for buildings used in the Company's day-to-day operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Information about market risk is set forth above in the "Interest Rate Sensitivity" and "Derivatives and Market Risk Exposure" sections of the Management's Discussion and Analysis.

Table of Contents

Item 8. Financial Statements and Supplementary Data

Consolidated Balance Sheets

$ in thousands, except per share data	December 31, 2017	2016
Assets		
Cash and due from banks	$ 12,926	$ 13,974
Interest-bearing deposits	51,233	80,268
Securities available for sale, at fair value	331,387	304,282
Securities held to maturity (fair value of $130,113 at December 31, 2017 and $137,692 at December 31, 2016)	127,164	134,957
Restricted stock	1,200	1,170
Mortgage loans held for sale	260	478
Loans:		
Real estate construction loans	34,694	36,345
Consumer real estate loans	166,965	157,718
Commercial real estate loans	340,414	336,457
Commercial non real estate loans	40,518	39,024
Public sector and IDA loans	51,443	45,474
Consumer non real estate loans	34,648	33,528
Total loans	668,682	648,546
Less unearned income and deferred fees and costs	(613)	(794)
Loans, net of unearned income and deferred fees and costs	668,069	647,752
Less allowance for loan losses	(7,925)	(8,300)
Loans, net	660,144	639,452
Premises and equipment, net	8,221	8,853
Accrued interest receivable	5,297	5,260
Other real estate owned, net	2,817	3,156
Intangible assets and goodwill	5,898	5,966
Bank-owned life insurance (BOLI)	33,756	22,998
Other assets	16,454	13,128
Total assets	$ 1,256,757	$ 1,233,942
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	$ 182,511	$ 171,946
Interest-bearing demand deposits	622,189	604,093
Savings deposits	140,150	136,789
Time deposits	114,884	130,614
Total deposits	1,059,734	1,043,442
Accrued interest payable	62	55
Other liabilities	12,065	12,182
Total liabilities	1,071,861	1,055,679
Commitments and contingencies		

Stockholders' equity:		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	***---***	*---*
Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding, 6,957,974 shares in 2017 and 2016	***8,698***	*8,698*
Retained earnings	***185,893***	*178,224*
Accumulated other comprehensive loss, net	***(9,695)***	*(8,659)*
Total stockholders' equity	***184,896***	*178,263*
Total liabilities and stockholders' equity	**$*1,256,757***	$*1,233,942*

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Consolidated Statements of Income

	Years ended December 31,		
$ in thousands, except per share data	**2017**	**2016**	**2015**
Interest Income			
Interest and fees on loans	**$29,932**	$29,365	$30,446
Interest on interest-bearing deposits	**791**	532	254
Interest and dividends on securities – taxable	**5,711**	5,910	6,776
Interest on securities – nontaxable	**4,826**	5,123	5,438
Total interest income	**41,260**	40,930	42,914
Interest Expense			
Interest on deposits	**4,125**	4,166	4,183
Total interest expense	**4,125**	4,166	4,183
Net interest income	**37,135**	36,764	38,731
Provision for loan losses	**157**	1,650	2,009
Net interest income after provision for loan losses	**36,978**	35,114	36,722
Noninterest Income			
Service charges on deposit accounts	**2,776**	2,458	2,250
Other service charges and fees	**205**	212	215
Credit card fees	**3,948**	3,798	3,861
Trust income	**1,530**	1,346	1,229
BOLI income	**758**	597	603
Other income	**1,148**	1,289	1,295
Realized securities gains, net	**14**	232	33
Total noninterest income	**10,379**	9,932	9,486
Noninterest Expense			
Salaries and employee benefits	**13,746**	12,792	12,522
Occupancy, furniture and fixtures	**1,820**	1,849	1,743
Data processing and ATM	**2,275**	2,186	1,657
FDIC assessment	**364**	476	546
Credit card processing	**2,748**	2,782	2,692
Intangible assets amortization	**68**	257	999
Net costs of other real estate owned	**205**	472	608
Franchise taxes	**1,315**	1,296	1,288
Other operating expenses	**4,431**	4,042	3,580
Total noninterest expense	**26,972**	26,152	25,635
Income before income taxes	**20,385**	18,894	20,573
Income tax expense	**6,293**	3,952	4,740
Net income	**$14,092**	$14,942	$15,833
Basic net income per common share	**$2.03**	$2.15	$2.28
Fully diluted net income per common share	**$2.03**	$2.15	$2.28

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Consolidated Statements of Comprehensive Income

$ in thousands, except per share data	Years ended December 31, 2017	2016	2015
Net Income	**$14,092**	$14,942	$15,833
Other Comprehensive Income (Loss), Net of Tax			
Unrealized holding gain (loss) on available for sale securities net of tax of $296 in 2017, ($431) in 2016 and ($571) in 2015	**546**	(800)	(1,064)
Reclassification adjustment for gain included in net income, net of tax of ($4) in 2017, ($65) in 2016 and ($12) in 2015	**(6)**	(121)	(21)
Net pension gain (loss) arising during the period, net of tax of $115 in 2017, $132 in 2016 and ($597) in 2015	**213**	271	(1,108)
Less amortization of prior service cost included in net periodic pension cost, net of tax of ($38) in 2017, ($38) in 2016 and ($38) in 2015	**(71)**	(72)	(72)
Other comprehensive income (loss), net of tax of $369 in 2017, ($402) in 2016 and ($1,218) in 2015	**682**	(722)	(2,265)
Total Comprehensive Income	**$14,774**	$14,220	$13,568

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity

$ in thousands, except per share data	Common Stock	Retained Earnings	Accumulated Other Comprehensive (Loss)	Total
Balance at December 31, 2014	$8,688	$163,287	$ (5,672)	$166,303
Net income	---	15,833	---	15,833
Other comprehensive loss, net of tax of ($1,218)	---	---	(2,265)	(2,265)
Cash dividend ($1.14 per share)	---	(7,930)	---	(7,930)
Exercise of stock options	10	163	---	173
Balance at December 31, 2015	$8,698	$171,353	$ (7,937)	$172,114
Net income	---	14,942	---	14,942
Other comprehensive loss, net of tax of ($402)	---	---	(722)	(722)
Cash dividend ($1.16 per share)	---	(8,071)	---	(8,071)
Balance at December 31, 2016	$8,698	$178,224	$ (8,659)	$178,263
Net income	---	14,092	---	14,092
Other comprehensive income, net of tax of $369	---	---	682	682

Cash dividend ($1.17 per share)	---	*(8,141)*	---	*(8,141)*
Reclassification of stranded tax effects from change in tax rate	---	*1,718*	*(1,718)*	---
Balance at December 31, 2017	**$ *8,698***	**$ *185,893***	**$ *(9,695)***	**$ *184,896***

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Consolidated Statements of Cash Flows

	Years Ended December 31,		
$ in thousands	**2017**	**2016**	**2015**
Cash Flows from Operating Activities			
Net income	**$14,092**	$14,942	$15,833
Adjustment to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	**157**	1,650	2,009
Deferred income tax expense	**1,790**	18	10
Re-valuation of deferred tax assets	**1,560**	---	---
Depreciation of premises and equipment	**805**	801	749
Amortization of intangibles	**68**	257	999
Amortization of premiums and accretion of discounts, net	**58**	89	117
Gain on disposal of fixed assets	**(134)**	---	15
Gain on calls and sales of securities available for sale, net	**(10)**	(186)	(33)
Gain on calls of securities held to maturity, net	**(4)**	(46)	---
Loss and writedown on other real estate owned	**125**	355	426
Income on investment in BOLI	**(758)**	(597)	(603)
Gain on sale of mortgage loans held for sale	**(211)**	(280)	(273)
Origination of mortgage loans held for sale	**(13,912)**	(17,090)	(17,641)
Sale of mortgage loans held for sale	**14,341**	17,526	17,571
Contribution to defined benefit plan	**(4,507)**	(811)	(139)
Net change in:			
Accrued interest receivable	**(37)**	509	(21)
Other assets	**(2,537)**	438	559
Accrued interest payable	**7**	(1)	(12)
Other liabilities	**101**	(41)	963
Net cash provided by operating activities	**10,994**	17,533	20,529
Cash Flows from Investing Activities			
Net change in interest-bearing deposits	**29,035**	50,543	(28,263)
Proceeds from repayments of mortgage-backed securities	**298**	415	717
Proceeds from calls, sales and maturities of securities available for sale	**13,812**	220,581	64,556
Proceeds from calls and maturities of securities held to maturity	**8,975**	16,945	9,205
Purchases of securities available for sale	**(40,290)**	(290,296)	(80,093)
Purchases of securities held to maturity	**(1,319)**	---	---
Net change in restricted stock	**(30)**	(41)	(40)
Purchase of BOLI	**(10,000)**	---	---
Purchases of loan participations	**(7,395)**	(3,800)	(1,001)
Collections of loan participations	**2,113**	820	1,978
Loan originations and principal collections, net	**(15,951)**	(27,792)	(17,259)
Proceeds from disposal of other real estate owned	**311**	877	773
Recoveries on loans charged off	**287**	159	145
Additions to premises and equipment	**(261)**	(634)	(663)
Proceeds from sale of premises and equipment	**222**	---	---

Net cash used in investing activities	**(20,193)**	(32,223)	(49,945)
Cash Flows from Financing Activities			
Net change in time deposits	**(15,730)**	(21,147)	(22,723)
Net change in other deposits	**32,022**	45,730	59,154
Cash dividends paid	**(8,141)**	(8,071)	(7,930)
Stock options exercised	**---**	---	173
Net cash provided by financing activities	**8,151**	16,512	28,674
Net change in cash and due from banks	**(1,048)**	1,822	(742)
Cash and due from banks at beginning of year	**13,974**	12,152	12,894
Cash and due from banks at end of year	**$12,926**	$13,974	$12,152
Supplemental Disclosures of Cash Flow Information			
Interest paid on deposits and borrowed funds	**$4,118**	$4,167	$4,195
Income taxes paid	**4,092**	3,940	4,790
Supplemental Disclosures of Noncash Activities			
Loans charged against the allowance for loan losses	**$819**	$1,806	$2,120
Loans transferred to other real estate owned	**97**	222	620
Unrealized gain (loss) on securities available for sale	**832**	(1,417)	(1,668)
Minimum pension liability adjustment	**219**	293	(1,815)

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Notes to Consolidated Financial Statements

$ in thousands, except per share data

Note *1:* Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of National Bankshares, Inc. (Bankshares) and its wholly-owned subsidiaries, the National Bank of Blacksburg (NBB), and National Bankshares Financial Services, Inc. (NBFS), (the Company). All intercompany balances and transactions have been eliminated in consolidation.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The following is a summary of the more significant accounting policies.

Subsequent events have been considered through the date when the Form *10*-K was issued.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and amounts due from banks.

Interest-Bearing Deposits

The Company invests over-night funds in interest-bearing deposits at other banks, including the Federal Home Loan Bank, the Federal Reserve, and other entities. Interest-bearing deposits are carried at cost.

Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities *not* classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. The Company uses the interest method to recognize purchase premiums and discounts in interest income over the term of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company follows the accounting guidance related to recognition and presentation of other-than-temporary impairment. The guidance specifies that if (a) an entity does *not* have the intent to sell a debt security prior to recovery and (b) it is more likely than *not* that the entity will *not* have to sell the debt security prior to recovery, the security

would *not* be considered other-than-temporarily impaired, unless there is a credit loss. When criteria (a) and (b) are met, the entity will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

For equity securities, when the Company decides to sell an impaired available-for-sale security and the Company does *not* expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has *not* been made.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Loans held for sale are sold with the mortgage servicing rights released by the Company.

Loans

The Company, through its banking subsidiary, provides mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans, particularly commercial mortgages. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company's market area.

The Company's loans are grouped into *six* segments: real estate construction, consumer real estate, commercial real estate, commercial non real estate, public sector and IDA, and consumer non real estate. Each segment is subject to certain risks that influence the establishment of pricing, loan structures, approval requirements, reserves, and ongoing credit management.

Real estate construction loans are subject to general risks from changing commercial building and housing market trends and economic conditions that *may* impact demand for completed properties and the costs of completion. Completed properties that do *not* sell or become leased within originally expected timeframes *may* impact the borrower's ability to service the debt. These risks are measured by market-area unemployment rates, bankruptcy rates, housing and commercial building market trends, and interest rates. Risks specific to the borrower are also evaluated, including previous repayment history, debt service ability, and current and projected loan-to value ratios for the collateral.

The credit quality of consumer real estate is subject to risks associated with the borrower's repayment ability and collateral value, measured generally by analyzing local unemployment and bankruptcy trends, and local housing market trends and interest rates. Risks specific to a borrower are determined by previous repayment history, loan-to-value ratios and debt-to-income ratios.

Table of Contents

The commercial real estate segment includes loans secured by multifamily residential real estate, commercial real estate occupied by the owner/borrower, and commercial real estate leased to non-owners. Loans in the commercial real estate segment are impacted by economic risks from changing commercial real estate markets, rental markets for multi-family housing and commercial buildings, business bankruptcy rates, local unemployment rates and interest rate trends that would impact the businesses housed by the commercial real estate.

Commercial non real estate loans are secured by collateral other than real estate, or are unsecured. Credit risk for commercial non real estate loans is subject to economic conditions, generally monitored by local business bankruptcy trends, interest rates, borrower repayment ability and collateral value (if secured).

Public sector and IDA loans are extended to municipalities and related entities. Credit risk is based upon the entity's ability to repay through either a direct obligation or assignment of specific revenues from an enterprise or other economic activity, and interest rate trends.

Consumer non real estate includes credit cards, automobile and other consumer loans. Credit cards and certain other consumer loans are unsecured, while collateral is obtained for automobile loans and other consumer loans. Credit risk stems primarily from the borrower's ability to repay. If the loan is secured, the company analyzes loan-to-value ratios. All consumer non real estate loans are analyzed for debt-to-income ratios and previous credit history, as well as for general risks for the portfolio, including local unemployment rates, personal bankruptcy rates and interest rates.

Risks from delinquency trends and characteristics such as *second*-lien position and interest-only status, as well as historical charge-off rates, are analyzed for all segments.

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses, any purchase premium or discount, unearned income and deferred fees or costs. Interest income is accrued on the unpaid principal balance. Unearned income on dealer-originated loans and loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. Purchase premium or discount is recognized as an adjustment of the related loan yield using the interest method.

The Company considers multiple factors when determining whether to discontinue accrual of interest on individual loans. Generally loans are placed in nonaccrual status when collection of interest and/or full principal is considered doubtful. Interest accrual is discontinued at the time a commercial real estate loan or commercial non-real estate loan is *90* days delinquent unless the credit is well secured and in the process of collection. Loans within all loan classes that are *not* restructured but that are impaired and have an associated impairment loss are placed on nonaccrual unless the borrower is paying as agreed. Restructured loans within all classes that allow the borrower to discontinue payments of principal or interest for more than *90* days are placed on nonaccrual unless the modification provides reasonable assurance of repayment performance and collateral value supports regular underwriting requirements. Restructured loans within all classes that maintain current status for at least a *six*-month period, including history prior to restructuring, *may* be returned to accrual status.

All interest accrued but *not* collected for loans of all classes that are placed on nonaccrual or for loans charged off is reversed against interest income. Any interest payments received on nonaccrual loans of all classes are credited to the principal balance of the loan. Loans of all classes that have been designated nonaccrual are returned to accrual status when all the principal and interest amounts contractually due are current; future payments are reasonably assured; and for loans that financed the sale of OREO property, loan-to-value thresholds are met. The Company reviews nonaccrual loans on an individual loan basis to determine whether future payments are reasonably assured. In order for this criteria to be satisfied, the Company's evaluation must determine that the underlying cause of the original delinquency

or weakness that indicated nonaccrual status has been resolved, such as receipt of new guarantees, increased cash flows that cover the debt service or other resolution.

A loan is considered past due when a payment of principal and/or interest is due but *not* paid. Credit card payments *not* received within *30* days after the statement date, real estate loan payments *not* received within the payment cycle; and all other non-real estate secured loans for which payment is *not* made within the required payment cycle are considered *30* days past due. Management closely monitors past due loans in timeframes of *30-89* days past due and *90* or more days past due.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable losses inherent in the Company's loan portfolio. A provision for estimated losses is charged to earnings to establish and maintain the allowance for loan losses at a level reflective of the estimated credit risk. When management determines that a loan balance or portion of a loan balance is *not* collectible, the loss is charged against the allowance. Subsequent recoveries, if any, are credited to the allowance.

Management evaluates the allowance each quarter through a methodology that estimates losses on individual impaired loans and evaluates the effect of numerous factors on the credit risk of groups of homogeneous loans.

Specific allowances are established for individually-evaluated impaired loans based on the excess of the loan balance relative to the fair value of the loan. Impaired loans are designated as such when current information indicates that it is probable that the Company will be unable to collect principal or interest when due according to the contractual terms of the loan agreement. Loan relationships exceeding *$250,000* in nonaccrual status or that are significantly past due, or for which a credit review identified weaknesses that indicate principal and interest will *not* be collected according to the loan terms, as well as all loans modified in a troubled debt restructuring, are designated impaired. This policy is applicable to all loan classes.

Table of Contents

Fair value of impaired loans is estimated in *one* of *three* ways: (*1*) the estimated fair value (less selling costs) of the underlying collateral, (*2*) the present value of the loan's expected future cash flows, or (*3*) the loan's observable market value. The amount of recorded investment (unpaid principal net of any interest payments made by the borrower during the nonaccrual period and net of any partial charge-offs, accrued interest and deferred fees and costs) in an impaired loan that exceeds the fair value is accrued as estimated loss in the allowance. Impaired loans for which collection of interest or principal is in doubt are placed in nonaccrual status.

General allowances are established for collectively-evaluated loans. Collectively-evaluated loans are grouped into classes based on similar characteristics. Factors considered in determining general allowances include net charge-off trends, internal risk ratings, delinquency and nonperforming rates, product mix, underwriting practices, industry trends and economic trends.

The Company's charge-off policy meets or is more stringent than the minimum standards required by regulators. When available information confirms that a specific loan or a portion thereof, within any loan class, is uncollectible the amount is charged off against the allowance for loan losses. Additionally, losses on consumer real estate and consumer non-real estate loans are typically charged off *no* later than when the loans are *120-180* days past due, and losses on loans secured by residential real estate or by commercial real estate are charged off by the time the loans reach *180* days past due, in compliance with regulatory guidelines. Accordingly, secured loans *may* be charged down to the estimated value of the collateral, with previously accrued unpaid interest reversed. Subsequent charge-offs *may* be required as a result of changes in the market value of collateral or other repayment prospects.

Troubled Debt Restructurings ("TDRs")

In situations where, for economic or legal reasons related to a borrower's financial condition, management grants a concession to the borrower that it would *not* otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). These modified terms *may* include reduction of the interest rate, extension of the maturity date at an interest rate lower than the current market rate for a new loan with similar risk, forgiveness of principal or accrued interest or other actions intended to minimize the economic loss. TDR loans are individually measured for impairment.

Rate Lock Commitments

The Company enters into commitments to originate mortgage loans in which 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 Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, by committing 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 Company 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 effort contracts are *not* actively traded in stand-alone markets. The Company

determines the fair value of rate lock commitments and best efforts contracts by measuring the changes in the value of the underlying assets 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.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, net of accumulated depreciation. Depreciation is charged to expense over the estimated useful lives of the assets on the straight-line basis. Depreciable lives include *40* years for premises, *3-10* years for furniture and equipment, and *3* years for computer software. Costs of maintenance and repairs are charged to expense as incurred and improvements are capitalized.

Other Real Estate Owned

Real estate acquired through or in lieu of foreclosure is held for sale and is initially recorded at fair value less estimated costs to sell at the date of foreclosure, establishing the cost basis of the asset. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated costs to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other operating expenses.

Intangible Assets and Goodwill

The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs its annual analysis as of *September 30* of each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a *two*-step process for impairment testing of goodwill. The *first* step tests for impairment, while the *second* step, if necessary, measures the impairment.

Table of Contents

The Company's goodwill impairment analysis considered *three* valuation techniques appropriate to the measurement. The *first* technique uses the Company's market capitalization as an estimate of fair value, the *second* technique estimates fair value using current market pricing multiples for companies comparable to NBI, while the *third* technique uses current market pricing multiples for change-of-control transactions involving companies comparable to NBI. Certain key judgments were used in the valuation measurement. Goodwill is held by the Company's bank subsidiary. The bank subsidiary is *100%* owned by the Company, and *no* market capitalization is available. Because most of the Company's assets are comprised of the subsidiary bank's equity, the Company's market capitalization was used to estimate the Bank's market capitalization. Other judgments include the assumption that the companies and transactions used as comparables for the *second* and *third* technique were appropriate to the estimate of the Company's fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.

Each measure indicated that the Company's fair value exceeded its book value. *No* indicators of impairment for goodwill were identified during the years ended *December 31, 2017, 2016* and *2015.*

Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company amortizes on a straight-line basis intangible assets arising from branch purchase transactions over their useful lives, determined by the Company to be *ten* to *twelve* years. Core deposit intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

Stock-Based Compensation

The Company's *1999* Stock Option Plan terminated on *March 9, 2009.* Incentive stock options, all of which have been exercised or expired, were granted in the early years of the Plan. The Company recognized the cost of employment services received in exchange for awards of equity instruments based on the fair value of those awards on the date of grant. Compensation cost was recognized over the award's required service period, which was the vesting period.

Pension Plan

The Company recognizes the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognizes changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the projected benefit obligation.

Income Taxes

Income tax accounting guidance results in *two* components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred

income taxes using the asset and liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

In *February 2018,* the FASB issued ASU *2018-02,* Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("AOCI"). The Company early adopted this new standard in the current year. ASU *2018-01* requires reclassification from AOCI to retained earnings for stranded tax effects resulting from the impact of the newly enacted federal corporate income tax rate on items included in AOCI. The amount of this reclassification in *2017* was *$1,718.*

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than *not,* based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than *not* means a likelihood of more than *50* percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-*not* recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than *50* percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or *not* a tax position has met the more-likely-than-*not* recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than *not* that some portion or all of a deferred tax asset will *not* be realized.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

The results for the year and the *three* months ended *December 31, 2017* include the effect of the Tax Cuts and Jobs Act ("the Act"), which was signed into law on *December 22, 2017.* The Act becomes effective *January 1, 2018* and among other things, permanently lowers the federal corporate income tax rate to *21%* from the maximum rate prior to the passage of the Act of *35%.* When the federal corporate income tax rate changes, U.S. GAAP requires companies to re-measure their deferred tax assets and deferred tax liabilities, including those accounted for in accumulated other comprehensive income, as of the date of enactment, and record the corresponding effects as income tax expense. As a result of the permanent reduction in the corporate income tax rate, the Company recognized in the *fourth* quarter of *2017* a *$1,560* reduction in the value of its net deferred tax asset and recorded a corresponding incremental income tax expense of *$1,560* in its consolidated results of operations. The Company's evaluation of the effect of the Act is subject to refinement for up to *one* year after enactment.

Table of Contents

Trust Assets and Income

Assets (other than cash deposits) held by the Trust Department in a fiduciary or agency capacity for customers are *not* included in the consolidated financial statements since such items are *not* assets of the Company. Trust income is recognized on the accrual basis.

Earnings Per Common Share

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that *may* be issued by the Company relate solely to stock options outstanding during the period and are determined using the treasury stock method.

The following shows the weighted average number of shares used in computing earnings per common share and the effect on the weighted average number of shares of potentially dilutive common stock.

	2017	**2016**	**2015**
Average number of common shares outstanding	***6,957,974***	*6,957,974*	*6,953,849*
Effect of dilutive options	**---**	---	*3,245*
Average number of common shares outstanding used to calculate diluted earnings per common share	***6,957,974***	*6,957,974*	*6,957,094*

The computation of diluted net income per common share excludes shares for stock options that would be anti-dilutive. There were *no* anti-dilutive shares in *2017, 2016* or *2015.* As of *December 31, 2015,* there were *no* potential common shares outstanding.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business are recorded as liabilities when the likelihood of loss is probable and reasonably estimated. Management does *not* believe there are such matters that will have a material effect on the financial statements.

Advertising

The Company charges advertising costs to expenses as incurred. In *2017,* the Company expensed *$148,* and expensed *$122* and *$105* in *2016* and *2015,* respectively.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed real estate, other-than-temporary impairments of securities, evaluation of impairment of goodwill, and pension obligations.

Changing economic conditions, adverse economic prospects for borrowers, as well as regulatory agency action as a result of examination, could cause NBB to recognize additions to the allowance for loan losses and *may* also affect the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.

Reclassifications

Certain reclassifications have been made to prior period balances to conform to the current year provisions. Prior to *2017,* the Company reported certain IRA accounts in interest-bearing demand deposit accounts and in time deposits. During *2017,* the Company re-classified the accounts as savings accounts. In order to provide comparability to prior periods, deposits have been adjusted to reflect the reclassification in each year reported.

Table of Contents

Recent Accounting Pronouncements

In *May 2014,* the FASB issued ASU *No. 2014-09,* "Revenue from Contracts with Customers: Topic *606."* This ASU revised guidance for the recognition, measurement, and disclosure of revenue from contracts with customers. The original guidance has been amended through subsequent accounting standard updates that resulted in technical corrections, improvements, and a *one*-year deferral of the effective date to *January 1, 2018.* The guidance, as amended, is applicable to all entities and, once effective, will replace significant portions of existing industry and transaction-specific revenue recognition rules with a more principles-based recognition model. Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of the guidance. Gains and losses on investment securities, derivatives, and sales of financial instruments are similarly excluded from the scope. Entities can elect to adopt the guidance either on a full or modified retrospective basis. Full retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the earliest comparative period presented. Modified retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the reporting period in which the entity *first* applies the new guidance. The Company plans to adopt this guidance on the effective date, *January 1, 2018* via the modified retrospective approach. The Company has completed its assessment of the adoption of this ASU, noting the standard will result in expanded disclosures related to non-interest income and enhance the qualitative disclosures on the revenues within the scope of the new guidance. The Company has concluded the adoption of ASU *2014-09* will *not* have a material impact on its consolidated financial statements.

In *January 2016,* the FASB issued ASU *2016-01,* "Financial Instruments – Overall (Subtopic *825-10*): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU *2016-01,* among other things: *1*) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. *2*) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. *3*) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). *4*) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for fiscal years beginning after *December 15, 2017,* including interim periods within those fiscal years. The Company does *not* expect the adoption of ASU *2016-01* to have a material impact on its consolidated financial statements. The Company hired a vendor to assist with exit price disclosures.

Table of Contents

In *February 2016,* the FASB issued ASU *No. 2016-02,* "Leases (Topic *842*)." Among other things, in the amendments in ASU *2016-02,* lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (*1*) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (*2*) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic *606,* Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after *December 15, 2018,* including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would *not* require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors *may not* apply a full retrospective transition approach. The Company is currently assessing the impact that ASU *2016-02* will have on its consolidated financial statements. The Company is the lessee of *six* banking locations and *one* ATM location, the majority of which meet the standard's definition of a financing lease. At the effective date, the Company will recognize a lease liability and a right-of-use asset. Pro-forma analysis based on current lease contracts indicates that the lease liability and the right-of-use asset are similar in amount, with only nominal difference. The Company is the lessor of *three* properties, which will be treated as short-term operating leases.

During *June 2016,* the FASB issued ASU *No. 2016-13,* "Financial Instruments – Credit Losses (Topic *326*): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after *December 15, 2019.* The Company is currently assessing the impact that ASU *2016-13* will have on its consolidated financial statements. The Company has formed a working group to address information requirements, determine methodology, research forecasts and ensure readiness and compliance with the standard. The Company's existing model provider has released a CECL model and the Company will run multiple concurrent models prior to the effective date.

During *August 2016,* the FASB issued ASU *No. 2016-15,* "Statement of Cash Flows (Topic *230*): Classification of Certain Cash Receipts and Cash Payments", to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for fiscal years beginning after *December 15, 2017,* and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does *not* expect the adoption of ASU *2016-15* to have a material impact on its consolidated financial statements.

During *January 2017,* the FASB issued ASU *No. 2017-01,* "Business Combinations (Topic *805*): Clarifying the Definition of a Business". The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic *805,* there are *three* elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set")

that is a business usually has outputs, outputs are *not* required to be present. In addition, all the inputs and processes that a seller uses in operating a set are *not* required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is *not* a business. If the screen is *not* met, the amendments (*1*) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (*2*) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after *December 15, 2017,* including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. *No* disclosures are required at transition. The Company does *not* expect the adoption of ASU *2017-01* to have a material impact on its consolidated financial statements.

During *January 2017,* the FASB issued ASU *No. 2017-04,* "Intangibles – Goodwill and Other (Topic *350*): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step *2* from the goodwill impairment test. Step *2* measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after *December 15, 2019.* Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after *January 1, 2017.* The Company does *not* expect the adoption of ASU *2017-04* to have a material impact on its consolidated financial statements.

Table of Contents

During *March 2017,* the FASB issued ASU *2017-07,* "Compensation — Retirement Benefits (Topic *715*): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic *715* to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented in the income statement separately from the service cost component. If the other components of net periodic benefit cost are *not* presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after *December 15, 2017,* including interim periods within those annual periods. Early adoption is permitted. The Company does *not* expect the adoption of ASU *2017-07* to have a material impact on its consolidated financial statements.

During *March 2017,* the FASB issued ASU *2017 08,* "Receivables—Nonrefundable Fees and Other Costs (Subtopic *310 20*), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after *December 15, 2018,* and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU *2017 08* will have on its consolidated financial statements.

During *May 2017,* the FASB issued ASU *2017 09,* "Compensation – Stock Compensation (Topic *718*): Scope of Modification Accounting." The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic *718.* The amendments are effective for annual periods, including interim periods within those annual periods, beginning after *December 15, 2017.* Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have *not* yet been issued. The Company is currently assessing the impact that ASU *2017 09* will have on its consolidated financial statements.

During *August 2017,* the FASB issued ASU *2017-12,* "Derivatives and Hedging (Topic *815*): Targeted Improvements to Accounting for Hedging Activities." The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after *December 15, 2018.* Early adoption is permitted, including adoption in any interim period. The Company is currently assessing the impact that ASU *2017 12* will have on its consolidated financial statements.

During *February 2018,* the FASB issued ASU *2018-02,* "Income Statement – Reporting Comprehensive Income (Topic *220*): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." The amendments provide financial statement preparers with an option to reclassify stranded tax effects within accumulated other income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after *December 15, 2018,* and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to

each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company has elected to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act in the consolidated financial statements for the period ending *December 31, 2017*. The amount of this reclassification in *2017* was *$1,718*.

Note *2*: Restriction on Cash

The Company's subsidiary bank is a member of the Federal Reserve System. The Federal Reserve does *not* require member banks to hold an average balance in order to purchase services from the Federal Reserve.

Table of Contents

Note *3*: Securities

The amortized cost and fair value of securities available for sale, with gross unrealized gains and losses, follows:

	December 31, 2017			
Available for sale:	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Government agencies and corporations	**$*312,604***	**$ *609***	**$ *5,494***	**$*307,719***
States and political subdivisions	***16,853***	***100***	***119***	***16,834***
Mortgage-backed securities	***602***	***57***	***---***	***659***
Corporate debt securities	***6,016***	***188***	***29***	***6,175***
Total securities available for sale	**$*336,075***	**$ *954***	**$ *5,642***	**$*331,387***

	December 31, 2016			
Available for sale:	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Government agencies and corporations	$*291,271*	$ *492*	$ *6,165*	$*285,598*
States and political subdivisions	*11,482*	*211*	---	*11,693*
Mortgage-backed securities	*845*	*85*	---	*930*
Corporate debt securities	*6,015*	*20*	*137*	*5,898*
Other securities	*189*	---	*26*	*163*
Total securities available for sale	$*309,802*	$ *808*	$ *6,328*	$*304,282*

The amortized cost and fair value of single maturity securities available for sale at *December 31, 2017,* by contractual maturity, are shown below. Expected maturities *may* differ from contractual maturities because borrowers *may* have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at *December 31, 2017.*

	December 31, 2017	
Available for sale:	**Amortized Cost**	**Fair Value**
Due in one year or less	**$*33,405***	**$*33,238***
Due after one year through five years	***192,388***	***189,005***
Due after five years through ten years	***72,001***	***70,509***
Due after ten years	***38,281***	***38,635***

Total securities available for sale	**$*336,075***	**$*331,387***

The amortized cost and fair value of securities held to maturity, with gross unrealized gains and losses, follows:

	December 31, 2017			
Held to maturity:	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Government agencies and corporations	**$*3,934***	**$ *167***	**$ ---**	**$*4,101***
States and political subdivisions	***122,039***	***2,929***	***173***	***124,795***
Mortgage-backed securities	***209***	***21***	**---**	***230***
Corporate debt securities	***982***	***5***	**---**	***987***
Total securities held to maturity	**$*127,164***	**$ *3,122***	**$ *173***	**$*130,113***

Table of Contents

	December 31, 2016			
Held to maturity:	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Government agencies and corporations	$*3,934*	$ *201*	$ ---	$*4,135*
States and political subdivisions	*129,783*	*3,579*	*1,082*	*132,280*
Mortgage-backed securities	*265*	*30*	---	*295*
Corporate debt securities	*975*	*7*	---	*982*
Total securities held to maturity	$*134,957*	$ *3,817*	$ *1,082*	$*137,692*

The amortized cost and fair value of single maturity securities held to maturity at *December 31, 2017,* by contractual maturity, are shown below. Expected maturities *may* differ from contractual maturities because borrowers *may* have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at *December 31, 2017.*

	December 31, 2017	
Held to maturity:	**Amortized Cost**	**Fair Value**
Due in one year or less	**$*11,906***	**$*12,088***
Due after one year through five years	***24,403***	***25,359***
Due after five years through ten years	***25,242***	***25,892***
Due after ten years	***65,613***	***66,774***
Total securities held to maturity	**$*127,164***	**$*130,113***

Information pertaining to securities with gross unrealized losses at *December 31, 2017* and *2016* aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	December 31, 2017			
	Less Than 12 Months		**12 Months or More**	
	Fair Value	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U. S. Government agencies and corporations	**$*68,380***	**$ *871***	**$*225,738***	**$ *4,623***
State and political subdivisions	***18,688***	***194***	***2,989***	***98***
Corporate debt securities	***---***	***---***	***948***	***29***
Total temporarily impaired securities	**$*87,068***	**$ *1,065***	**$*229,675***	**$ *4,750***

	December 31, 2016	
	Less Than 12 Months	**12 Months or More**

	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U. S. Government agencies and corporations	$*260,150*	$ *6,161*	$*996*	$ *4*
State and political subdivisions	*31,257*	*934*	*1,316*	*148*
Corporate debt securities	*3,888*	*137*	---	---
Other securities	---	---	*163*	*26*
Total temporarily impaired securities	$*295,295*	$ *7,232*	$*2,475*	$ *178*

The Company had *343* securities with a fair value of *$316,743* that were temporarily impaired at *December 31, 2017.* The total unrealized loss on these securities was *$5,815.* Of the temporarily impaired total, *236* securities with a fair value of *$229,675* and an unrealized loss of *$4,750* have been in a continuous loss position for *twelve* months or more. The Company has determined that these securities are temporarily impaired at *December 31, 2017* for the reasons set out below.

U.S. Government agencies. The unrealized losses of *$4,623* on US Government agency securities stemmed from *231* securities with a fair value of *$225,738.* The unrealized losses were caused by interest rate and market fluctuations. The contractual term of the investment does *not* permit the issuer to settle the security at a price less than the cost basis of the investment. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does *not* intend to sell the investment and it is *not* likely that the Company will be required to sell the investment before recovery of its amortized cost basis, which *may* be at maturity, the Company does *not* consider this investment to be other-than-temporarily impaired.

Table of Contents

States and political subdivisions. This category exhibits unrealized losses of *$98* on *4* securities with a fair value of *$2,989.* The Company reviewed financial statements and cash flows for the each of the securities in continuous loss position for more than *12* months. The Company's analysis determined that the unrealized losses are primarily the result of interest rate and market fluctuations and *not* associated with impaired financial status. The contractual terms of the investments do *not* permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does *not* intend to sell any of the investments and it is *not* likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which *may* be at maturity, the Company does *not* consider these investments to be other-than-temporarily impaired.

Corporate debt securities. The unrealized loss of *$29* on *one* corporate debt security with a fair value of *$948* was caused by market and interest rate fluctuations and is *not* associated with impaired financial status. The contractual terms of the investments do *not* permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does *not* intend to sell the investment and it is *not* likely that the Company will be required to sell the investment before recovery of its amortized cost basis, which *may* be at maturity, the Company does *not* consider the investment to be other-than-temporarily impaired.

Restricted stock. The Company holds restricted stock of *$1,200* as of *December 31, 2017* and *$1,170* as of *December 31, 2016.* Restricted stock is reported separately from available-for-sale securities and held-to-maturity securities. As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital and a percentage of qualifying assets. The Company purchases stock from or sells stock back to the correspondents based on their calculations. The stock is held by member institutions only and is *not* actively traded.

Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB *may* declare dividends on the stock. In addition to dividends, NBB also benefits from its membership with FHLB through eligibility to borrow from the FHLB, using as collateral NBB's capital stock investment in the FHLB and qualifying NBB real estate mortgage loans totaling *$494,666* at *December 31, 2017.* Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at *December 31, 2017,* management did *not* determine any impairment.

Management regularly monitors the credit quality of the investment portfolio. Changes in ratings are noted and follow-up research on the issuer is undertaken when warranted. Management intends to carefully monitor any changes in bond quality.

Pledged Securities

At *December 31, 2017* and *2016,* securities with a carrying value of *$194,980* and *$178,121,* respectively, were pledged to secure municipal deposits and for other purposes as required or permitted by law.

Realized Securities Gains and Losses

During *2017,* the Company sold a small investment in community bank stock that resulted in a gain of *$4.* The investment was classified as available for sale and had book value of *$189.* All other realized gains and losses on securities during *2017, 2016* and *2015* resulted from calls of securities. Information pertaining to realized gains and

losses on called securities follows:

	For the year ended December 31, 2017				
	Proceeds	**Book Value**	**Gross Gain**	**Gross Loss**	**Net Gain**
Available for sale	***$13,620***	***$13,614***	***$ 6***	***$ ---***	***$ 6***
Held to maturity	***8,975***	***8,971***	***4***	***---***	***4***

	For the year ended December 31, 2016				
	Proceeds	**Book Value**	**Gross Gain**	**Gross Loss**	**Net Gain**
Available for sale	$*220,520*	$*220,334*	$ *186*	$ ---	$ *186*
Held to maturity	*16,160*	*16,114*	*46*	---	*46*

	For the year ended December 31, 2015				
	Proceeds	**Book Value**	**Gross Gain**	**Gross Loss**	**Net Gain**
Available for sale	$*63,775*	$*63,742*	$ *34*	$ *1*	$ *33*
Held to maturity	*7,605*	*7,605*	---	---	---

Note *4*: Related Party Transactions

In the ordinary course of business, the Company, through its banking subsidiary, has granted loans to related parties, including executive officers and directors of Bankshares and its subsidiaries. Total funded credit extended to related parties amounted to *$12,600* at *December 31, 2017* and *$9,445* at *December 31, 2016.* The amount of funded loans to related parties as of *December 31, 2016* includes loans to a director who retired in *2017* and loans identified during *2017.* Loans to related parties as of *December 31, 2017* exclude loans to the retired director. During the year ended *December 31, 2017,* total principal additions were *$7,407* and principal payments were *$3,996.* The Company held *$15,612* in deposits for related parties as of *December 31, 2017* and *$14,604* as of *December 31, 2016.* The Company leases to a director a small office space. The lease payments totaled *$5* in *2017* and *$5* in *2016.*

Table of Contents

Note *5*: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

The allowance for loan losses methodology incorporates individual evaluation of impaired loans and collective evaluation of groups of non-impaired loans. The Company performs ongoing analysis of the loan portfolio to determine credit quality and to identify impaired loans. Credit quality is rated based on the loan's payment history, the borrower's current financial situation and value of the underlying collateral.

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 will *not* be collected according to the contractual terms of the loan agreement. Impaired loans are those loans that have been modified in a troubled debt restructure ("TDR" or "restructure") and larger, non-homogeneous loans that are in nonaccrual or exhibit payment history or financial status that indicate that collection probably will *not* occur when due according to the loan's terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as "classified" or "other assets especially mentioned." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair value. Impaired loans that are *not* troubled debt restructures and for which fair value measurement indicates an impairment loss are designated nonaccrual. A restructured loan that maintains current status for at least *six* months *may* be in accrual status. Please refer to Note *1:* Summary of Significant Accounting Policies for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Restructured loans are individually evaluated for impairment, and the amount of a restructured loan's book value in excess of its fair value is accrued as a specific allocation in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were used in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent are charged down to fair value. Deficiencies indicated by impairment measurements for TDRs that are *not* collateral dependent *may* be accrued in the allowance for loan losses or charged off if deemed uncollectible.

Collectively-Evaluated Loans

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. The methodology for calculating reserves for collectively-evaluated loans is applied at the class level.

Portfolio Segments and Classes

The segments and classes used in determining the allowance for loan losses, beginning in *2013* are as follows.

Real Estate Construction	
Construction, residential	
Construction, other	Commercial Non Real Estate
	Commercial and Industrial
Consumer Real Estate	
Equity lines	Public Sector and IDA
Residential closed-end *first* liens	Public sector and IDA
Residential closed-end junior liens	
Investor-owned residential real estate	Consumer Non Real Estate
	Credit cards
Commercial Real Estate	Automobile
Multifamily real estate	Other consumer loans
Commercial real estate, owner-occupied	
Commercial real estate, other	

Historical Loss Rates

The Company's allowance methodology for collectively-evaluated loans applies historical loss rates by class to current class balances as part of the process of determining required reserves. Class loss rates are calculated as the net charge-offs for the class as a percentage of average class balance. The Company averages loss rates for the most recent *8* quarters to determine the historical loss rate for each class.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance ("class loss rate"), and total net charge-offs for the class as a percentage of average classified loans in the class ("classified loss rate"). Classified loans are those with risk ratings of "substandard" or lower. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

Table of Contents

Risk Factors

In addition to historical loss rates, risk factors pertinent to credit risk for each class are analyzed to estimate reserves for collectively-evaluated loans. Factors include changes in national and local economic and business conditions, the nature and volume of classes within the portfolio, loan quality, loan officers' experience, lending policies and the Company's loan review system.

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans, and the percentage of high risk loans within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Please refer to Note *1:* Summary of Significant Accounting Policies for a discussion of risk factors pertinent to each class.

Real estate construction loans are subject to general risks from changing commercial building and housing market trends and economic conditions that *may* impact demand for completed properties and the costs of completion. These risks are measured by market-area unemployment rates, bankruptcy rates, building market trends, and interest rates.

The credit quality of consumer real estate is subject to risks associated with the borrower's repayment ability and collateral value, measured generally by analyzing local unemployment and bankruptcy trends, local housing market trends, and interest rates.

The commercial real estate segment includes loans secured by multifamily residential real estate, commercial real estate occupied by the owner/borrower, and commercial real estate leased to non-owners. Loans in the commercial real estate segment are impacted by economic risks from changing commercial real estate markets, rental markets for multi-family housing and commercial buildings, business bankruptcy rates, local unemployment and interest rate trends that would impact the businesses housed by the commercial real estate.

Commercial non real estate loans are secured by collateral other than real estate, or are unsecured. Credit risk for commercial non real estate loans is subject to economic conditions, generally monitored by local business bankruptcy trends, and interest rates.

Public sector and IDA loans are extended to municipalities and related entities. Credit risk is based upon the entity's ability to repay and interest rate trends.

Consumer non real estate includes credit cards, automobile and other consumer loans. Credit cards and certain other consumer loans are unsecured, while collateral is obtained for automobile loans and other consumer loans. Credit risk stems primarily from the borrower's ability to repay, measured by average unemployment, average personal bankruptcy rates and interest rates.

Factor allocations applied to each class are increased for loans rated special mention and increased to a greater extent for loans rated classified. The Company allocates additional reserves for "high risk" loans. High risk loans include junior liens, interest only and high loan to value loans.

60

Table of Contents

A detailed analysis showing the allowance roll-forward by portfolio segment and related loan balance by segment follows:

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2017

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2016	$ 438	$ 1,830	$ 3,738	$ 1,063	$ 330	$ 644	$ 257	$ 8,300
Charge-offs	---	(146)	(139)	(82)	---	(452)	---	(819)
Recoveries	---	1	131	23	---	132	---	287
Provision for loan losses	(101)	342	(686)	68	89	383	62	157
Balance, December 31, 2017	$ 337	$ 2,027	$ 3,044	$ 1,072	$ 419	$ 707	$ 319	$ 7,925

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2016

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2015	$ 576	$ 1,866	$ 4,109	$ 655	$ 436	$ 627	$ 28	$ 8,297
Charge-offs	(29)	(133)	(488)	(883)	---	(273)	---	(1,806)
Recoveries	---	2	83	10	---	64	---	159
Provision for loan losses	(109)	95	34	(1,281)	(106)	226	229	1,650
Balance, December 31, 2016	$ 438	$ 1,830	$ 3,738	$ 1,063	$ 330	$ 644	$ 257	$ 8,300

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2015

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2014	$ 612	$ 1,662	$ 3,537	$ 1,475	$ 327	$ 602	$ 48	$ 8,263
Charge-offs	---	(205)	(1,114)	(490)	---	(311)	---	(2,120)
Recoveries	---	2	49	1	---	93	---	145
Provision for loan losses	(36)	407	1,637	(331)	109	243	(20)	2,009

Balance, December 31, 2015	$*576*	$ *1,866*	$ *4,109*	$ *655*	$ *436*	$ *627*	$ *28*	$*8,297*

Table of Contents

Allowance for Loan Losses by Segment and Evaluation Method as of December 31, 2017

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$---	$ *16*	$ ---	$ *160*	$ ---	$ *1*	$ ---	$*177*
Collectively evaluated for impairment	*337*	*2,011*	*3,044*	*912*	*419*	*706*	*319*	*7,748*
Total	$*337*	$ *2,027*	$ *3,044*	$ *1,072*	$ *419*	$ *707*	$ *319*	$*7,925*

Loans by Segment and Evaluation Method as of December 31, 2017

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$*2,882*	$*1,267*	$ *6,516*	$ *1,229*	$---	$ *30*	$ ---	$*11,924*
Collectively evaluated for impairment	*31,812*	*165,698*	*333,898*	*39,289*	*51,443*	*34,618*	---	*656,758*
Total	$*34,694*	$*166,965*	$ *340,414*	$ *40,518*	$*51,443*	$ *34,648*	$ ---	$*668,682*

Allowance for Loan Losses by Segment and Evaluation Method as of December 31, 2016

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$---	$ *25*	$ *1*	$ ---	$ ---	$ ---	$ ---	$*26*
Collectively evaluated for impairment	*438*	*1,805*	*3,737*	*1,063*	*330*	*644*	*257*	*8,274*
Total	$*438*	$ *1,830*	$ *3,738*	$ *1,063*	$ *330*	$ *644*	$ *257*	$*8,300*

Loans by Segment and Evaluation Method as of December 31, 2016

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$*270*	$*877*	$ *7,782*	$ *241*	$---	$ *3*	$ ---	$*9,173*
	36,075	*156,841*	*328,675*	*38,783*	*45,474*	*33,525*	---	*639,373*

Collectively evaluated for impairment								
Total	$*36,345*	$*157,718*	$*336,457*	$*39,024*	$*45,474*	$*33,528*	$ ---	$*648,546*

Table of Contents

A summary of ratios for the allowance for loan losses follows:

	December 31,	
	2017	2016
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs	***1.19%***	*1.28%*
Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs	***0.08%***	*0.26%*

A summary of nonperforming assets follows:

	December 31,	
	2017	2016
Nonperforming assets:		
Nonaccrual loans	**$*6***	$*1,168*
Restructured loans in nonaccrual	***2,763***	*4,687*
Total nonperforming loans	***2,769***	*5,855*
Other real estate owned, net	***2,817***	*3,156*
Total nonperforming assets	**$*5,586***	$*9,011*
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	***0.83%***	*1.38%*
Ratio of allowance for loan losses to nonperforming loans[1]	***286.20%***	*141.76%*

(*1*) The Company defines nonperforming loans as total nonaccrual and restructured loans that are nonaccrual. Loans *90* days past due and still accruing and accruing restructured loans are excluded.

A summary of loans past due *90* days or more and impaired loans follows:

	December 31,	
	2017	2016
Loans past due 90 days or more and still accruing	**$*51***	$*63*
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees and costs	***0.01%***	*0.01%*
Accruing restructured loans	**$*5,134***	$*3,769*
Impaired loans:		
Impaired loans with no valuation allowance	**$*10,444***	$*8,269*
Impaired loans with a valuation allowance	***1,480***	*904*
Total impaired loans	**$*11,924***	$*9,173*
Valuation allowance	**$*(177)***	$*(26)*
Impaired loans, net of allowance	**$*11,747***	$*9,147*
Average recorded investment in impaired loans[1]	**$*13,344***	$*11,585*

Income recognized on impaired loans, after designation as impaired	**$*528***	$*553*
Amount of income recognized on a cash basis	**$---**	$---

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

No interest income was recognized on nonaccrual loans for the years ended *December 31, 2017, 2016* or *2015.* Nonaccrual loans that meet the Company's balance thresholds are designated as impaired.

Table of Contents

A detailed analysis of investment in impaired loans, associated reserves and interest income recognized, by loan class follows:

	Impaired Loans as of December 31, 2017				
	(A) Principal Balance	Total Recorded Investment[1]	Recorded Investment[1] in (A) for Which There is No Related Allowance	Recorded Investment[1] in (A) for Which There is a Related Allowance	Related Allowance
Real Estate Construction[2]					
Construction other	$*2,882*	$ *2,882*	$ *2,882*	$ *---*	$ *---*
Consumer Real Estate[2]					
Residential closed-end first liens	***807***	***768***	***590***	***178***	***10***
Residential closed-end junior liens	***174***	***174***	***---***	***174***	***6***
Investor-owned residential real estate	***347***	***325***	***325***	***---***	***---***
Commercial Real Estate[2]					
Multifamily real estate	***303***	***303***	***303***	***---***	***---***
Commercial real estate, owner occupied	***3,619***	***3,611***	***3,611***	***---***	***---***
Commercial real estate, other	***2,921***	***2,602***	***2,602***	***---***	***---***
Commercial Non Real Estate[2]					
Commercial and Industrial	***1,236***	***1,229***	***126***	***1,103***	***160***
Consumer Non Real Estate[2]					
Automobile	***30***	***30***	***5***	***25***	***1***
Total	$*12,319*	$ *11,924*	$ *10,444*	$ *1,480*	$ *177*

	Impaired Loans as of December 31, 2016				
	(A) Principal Balance	Total Recorded Investment[1]	Recorded Investment[1] in (A) for Which There is No Related Allowance	Recorded Investment[1] in (A) for Which There is a Related Allowance	Related Allowance
Real Estate Construction[2]					
Construction 1-4 family residential	$*280*	$ *270*	$ *270*	$ ---	$ ---
Consumer Real Estate[2]					
Residential closed-end first liens	*648*	*609*	*267*	*342*	*14*
Residential closed-end junior liens	*195*	*195*	---	*195*	*7*
Investor-owned residential real estate	*73*	*73*	---	*73*	*4*
Commercial Real Estate[2]					
Multifamily real estate	*1,364*	*1,091*	*1,091*	---	---
Commercial real estate, owner occupied	*4,005*	*3,957*	*3,663*	*294*	*1*
Commercial real estate, other	*2,997*	*2,734*	*2,734*	---	---

Commercial Non Real Estate[2]					
Commercial and Industrial	*255*	*241*	*241*	*---*	*---*
Consumer Non Real Estate[2]					
Automobile	*3*	*3*	*3*	*---*	*---*
Total	$*9,820*	$ *9,173*	$ *8,269*	$ *904*	$ *26*

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(*2*) Only classes with impaired loans are shown.

Table of Contents

	Average Investment and Interest Income for Impaired Loans For the Year Ended December 31, 2017	
	Average Recorded Investment	Interest Income Recognized[1]
Real Estate Construction[2]		
Construction other	$*3,298*	$ *177*
Consumer Real Estate[2]		
Residential closed-end first liens	*781*	*57*
Residential closed-end junior liens	*185*	*11*
Investor-owned residential real estate	*329*	*1*
Commercial Real Estate[2]		
Multifamily real estate	*748*	*16*
Commercial real estate, owner occupied	*4,047*	*200*
Commercial real estate, other	*2,638*	*---*
Commercial Non Real Estate[2]		
Commercial and Industrial	*1,282*	*64*
Consumer Non Real Estate[2]		
Automobile	*36*	*2*
Total	$*13,344*	$ *528*

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

(*2*) Only classes with impaired loans are shown.

	Average Investment and Interest Income for Impaired Loans For the Year Ended December 31, 2016	
	Average Recorded Investment	Interest Income Recognized[1]
Real Estate Construction[2]		
Construction 1-4 family residential	$*462*	$ *10*

Consumer Real Estate[2]		
Residential closed-end first liens	*642*	*38*
Residential closed-end junior liens	*207*	*13*
Investor-owned residential real estate	*74*	*4*
Commercial Real Estate[2]		
Multifamily real estate	*1,366*	*12*
Commercial real estate, owner occupied	*4,342*	*206*
Commercial real estate, other	*3,947*	*263*
Commercial Non Real Estate[2]		
Commercial and Industrial	*541*	*7*
Consumer Non Real Estate[2]		
Automobile	*4*	---
Total	$*11,585*	$ *553*

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(*2*) Only classes with impaired loans are shown.

Table of Contents

	Average Investment and Interest Income for Impaired Loans For the Year Ended December 31, 2015	
	Average Recorded Investment	Interest Income Recognized[1]
Real Estate Construction[2]		
Construction 1-4 family residential	$*612*	$ *23*
Consumer Real Estate[2]		
Residential closed-end first liens	*681*	*43*
Residential closed-end junior liens	*228*	*15*
Investor-owned residential real estate	*76*	*5*
Commercial Real Estate[2]		
Multifamily real estate	*2,581*	*84*
Commercial real estate, owner occupied	*6,141*	*251*
Commercial real estate, other	*5,888*	*308*
Commercial Non Real Estate[2]		
Commercial and Industrial	*1,090*	*40*
Total	$*17,297*	$ *769*

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(*2*) Only classes with impaired loans are shown.

An analysis of past due and nonaccrual loans follows:

December 31, 2017

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction				
Construction, residential	**$---**	**$---**	**$ ---**	**$ ---**
Construction, other	**---**	**---**	**---**	**---**
Consumer Real Estate				
Equity lines	***---***	***---***	***---***	***---***
Residential closed-end first liens	***637***	***16***	***11***	***145***

Residential closed-end junior liens	***188***	***---***	***---***	***---***
Investor-owned residential real estate	***66***	***---***	***---***	***6***
Commercial Real Estate				
Multifamily real estate	***303***	***---***	***---***	***---***
Commercial real estate, owner occupied	***402***	***---***	***---***	***---***
Commercial real estate, other	***---***	***2,602***	***---***	***2,602***
Commercial Non Real Estate				
Commercial and Industrial	***131***	***---***	***---***	***15***
Public Sector and IDA				
Public sector and IDA	***---***	***---***	***---***	***---***
Consumer Non Real Estate				
Credit cards	***7***	***12***	***12***	***---***
Automobile	***375***	***22***	***22***	***1***
Other consumer loans	***154***	***6***	***6***	***---***
Total	**$*2,263***	**$*2,658***	**$ *51***	**$ *2,769***

Table of Contents

December 31, 2016

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction				
Construction, residential	$---	$---	$ ---	$ *270*
Construction, other	*25*	---	---	---
Consumer Real Estate				
Equity lines	*10*	---	---	---
Residential closed-end first liens	*1,498*	*6*	*6*	---
Residential closed-end junior liens	*114*	*36*	*36*	---
Investor-owned residential real estate	*56*	*234*	---	*253*
Commercial Real Estate				
Multifamily real estate	*132*	*1,091*	---	*1,091*
Commercial real estate, owner occupied	*339*	*202*	---	*1,183*
Commercial real estate, other	---	*80*	---	*2,814*
Commercial Non Real Estate				
Commercial and Industrial	*6*	*218*	---	*241*
Public Sector and IDA				
Public sector and IDA	---	---	---	---
Consumer Non Real Estate				
Credit cards	*8*	*5*	*5*	---
Automobile	*234*	*12*	*12*	*3*
Other consumer loans	*131*	*4*	*4*	---
Total	$*2,553*	$*1,888*	$ *63*	$ *5,855*

The estimate of credit risk for non-impaired loans is obtained by applying allocations for internal and external factors. The allocations are increased for loans that exhibit greater credit quality risk.

Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do *not* indicate heightened risk are graded as "pass." Loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than *75* days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans with frequent or persistent delinquency exceeding *75* days or that have a higher level of weakness in the borrower's financial condition are graded "classified." Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by *50%* and by *100%* for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of *December 31, 2017* and *2016.*

Table of Contents

The following displays non-impaired gross loans by credit quality indicator:

December 31, 2017

	Pass	Special Mention (Excluding Impaired)	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 family residential	**$*10,396***	**$ ---**	**$ ---**
Construction, other	***21,416***	**---**	**---**
Consumer Real Estate			
Equity lines	***16,673***	***39***	**---**
Closed-end first liens	***85,975***	***2,400***	***355***
Closed-end junior liens	***4,483***	***29***	***12***
Investor-owned residential real estate	***55,410***	***66***	***256***
Commercial Real Estate			
Multifamily residential real estate	***95,894***	***127***	**---**
Commercial real estate owner-occupied	***130,256***	***246***	***763***
Commercial real estate, other	***106,612***	**---**	**--**
Commercial Non Real Estate			
Commercial and Industrial	***38,904***	***220***	***165***
Public Sector and IDA			
States and political subdivisions	***51,443***	**---**	**---**
Consumer Non Real Estate			
Credit cards	***5,493***	**---**	**---**
Automobile	***16,059***	***218***	***116***
Other consumer	***12,692***	***16***	***24***
Total	**$*651,706***	**$ *3,361***	**$ *1,691***

Table of Contents

December 31, 2016

	Pass	Special Mention (Excluding Impaired)	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 family residential	$*11,635*	$ *3,648*	$ ---
Construction, other	*20,972*	---	---
Consumer Real Estate			
Equity lines	*17,034*	*82*	---
Closed-end first liens	*83,658*	*1,267*	*580*
Closed-end junior liens	*4,861*	*15*	*151*
Investor-owned residential real estate	*48,277*	*333*	*583*
Commercial Real Estate			
Multifamily residential real estate	*99,002*	*1,733*	---
Commercial real estate owner-occupied	*120,170*	*1,188*	*1,425*
Commercial real estate, other	*103,534*	*1,543*	*80*
Commercial Non Real Estate			
Commercial and Industrial	*35,521*	*3,229*	*33*
Public Sector and IDA			
States and political subdivisions	*45,474*	---	---
Consumer Non Real Estate			
Credit cards	*5,978*	---	---
Automobile	*14,457*	*25*	*192*
Other consumer	*12,229*	*636*	*8*
Total	$*622,802*	$ *13,519*	$ *3,052*

Sales, Purchases and Reclassification of Loans

The Company finances mortgages under “best efforts” contracts with mortgage purchasers. The mortgages are designated as held for sale upon initiation. There have been *no* major reclassifications from portfolio loans to held for sale. Occasionally, the Company purchases or sells participations in loans. All participation loans purchased met the Company’s normal underwriting standards at the time the participation was entered. Participation loans are included in the appropriate portfolio balances to which the allowance methodology is applied.

Table of Contents

Troubled Debt Restructurings

From time to time the Company modifies loans in troubled debt restructurings ("TDRs"). The following tables present restructurings by class that occurred during the years ended *December 31, 2017, 2016* and *2015.*

Note: Only classes with restructured loans are presented.

	Restructurings that occurred during the year ended		
	December 31, 2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment[1]
Consumer Real Estate			
Closed-end first lien	*1*	$ *8*	$ *8*
Commercial Real Estate			
Commercial real estate, other	*1*	*132*	*132*
Commercial Non Real Estate			
Commercial and industrial	*4*	*1,221*	*1,221*
Consumer Non Real Estate			
Automobile	*4*	*26*	*26*
Total	*10*	$ *1,387*	$ *1,387*

(*1*) Post-modification outstanding recorded investment considers amounts immediately following the modification. Amounts do *not* reflect balances at the end of the period.

Each of the restructurings completed during the *twelve* months ended *December 31, 2017* provided payment relief to the borrowers. The consumer real estate loan was modified to provide payment relief by extending the term. Impairment measurement was based on the present value of cash flows and did *not* result in a specific allocation.

The commercial real estate loan was restructured to reduce monthly debt service by lowering the interest rate slightly and changing the interest method from variable to fixed. Interest was capitalized and the loan was re-amortized over a longer term. Impairment measurement, based on the present value of cash flows, did *not* result in a specific allocation. The loan is in nonaccrual status and all payments made during the nonaccrual period are credited fully to principal, reducing the book balance below the present value of cash flows.

The *four* commercial non-real estate loans were restructured to reduce monthly debt service by increasing the amortization period. Three of the commercial non-real estate loans received rate reductions, and on *one* commercial non-real estate loan, the interest method was changed from variable to fixed. Impairment measurement, based on the present value of cash flows, indicated a specific reserve for *two* of the commercial non-real estate loans.

The *four* automobile loans were restructured pursuant to Chapter *13* bankruptcy requirements, reducing the interest rate and re-amortizing over a longer term to provide monthly debt service relief. One automobile loan restructuring included forgiveness of a small amount of principal to comply with the bankruptcy plan. Impairment measurement for all the restructured automobile loans was based on the present value of cash flows method and resulted in small specific allocations for each loan which totaled *$1*.

Table of Contents

	Restructurings that occurred during the year ended December 31, 2016		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment[1]
Commercial Real Estate			
Commercial real estate, other	*2*	$ *3,008*	$ *3,008*
Commercial Non Real Estate			
Commercial and industrial	*1*	*29*	*30*
Consumer Non Real Estate			
Automobile	*1*	*5*	*5*
Total	*4*	$ *3,042*	$ *3,043*

(*1*) Post-modification outstanding recorded investment considers amounts immediately following the modification. Amounts do *not* reflect balances at the end of the period.

During the *twelve*-month period ended *December 31, 2016,* the Company identified *four* loans as troubled debt restructurings. Two commercial real estate loans were originally modified in troubled debt restructurings in *2014* to provide payment relief by lowering the interest rate and allowing interest-only payments. The restructurings completed in *2016* lowered the interest rate from the *2014* restructured terms and returned the loans to amortization with payments of principal and interest. The loans were in nonaccrual status prior to the *2016* restructuring and will remain in nonaccrual until they have met the Company's policy to return to accrual status. The Company also identified during the year ended *December 31, 2016 one* commercial non-real estate loan and *one* automobile loan modified in troubled debt restructurings. The modifications provided payment relief by extending the maturity date and capitalizing interest. The loans are in nonaccrual status. Each of the *four* troubled debt restructurings are collateral dependent and the fair value is measured using the collateral method. Impairment measurement did *not* result in any specific allocations.

	Restructurings that occurred during the year ended December 31, 2015		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment[1]
Real Estate Construction			
Construction, 1-4 family residential	*2*	$ *718*	$ *718*
Commercial Real Estate			
Commercial real estate owner-occupied	*3*	*2,710*	*2,623*
Commercial Non Real Estate			

Commercial and industrial	*1*	*200*	*200*
Total	*6*	$ *3,628*	$ *3,541*

(*1*) Post-modification outstanding recorded investment considers amounts immediately following the modification. Amounts do *not* reflect balances at the end of the period.

During the *twelve*-month period ended *December 31, 2015,* the Company modified *six* loans in troubled debt restructurings in order to provide payment relief. One commercial real estate owner-occupied loan was restructured to forgive principal of *$100,* reduce the interest rate, capitalize interest and re-amortize payments. The fair value measurement of the restructured loan as of *December 31, 2015* resulted in *no* specific allocation to the allowance for loan losses. Two commercial real estate owner-occupied loans were modified during the *fourth* quarter of *2015* to require payments of interest only. As of *December 31, 2015,* the impairment analysis determined a combined allocation to the allowance for loan losses of *$23.* Two construction loans were modified during the *fourth* quarter of *2015* to become non-revolving and require payments of interest only. The fair value measurement of the restructured loans as of *December 31, 2015* resulted in *no* specific allocation to the allowance for loan losses. One commercial loan was restructured during the *fourth* quarter of *2015* to extend the maturity date. The fair value measurement of the restructured loan as of *December 31, 2015* resulted in *no* specific allocation to the allowance for loan losses.

Of the Company’s TDR’s that defaulted in *2017, 2016* and *2015, none* were modified within *12* months prior to default. The company defines default as *one* or more payments that occur more than *90* days past the due date, charge-off or foreclosure.

Table of Contents

Note *6*: Premises and Equipment

A summary of the cost and accumulated depreciation of premises and equipment follows:

	December 31,	
	2017	**2016**
Premises	**$*12,434***	$*12,554*
Furniture and equipment	***5,238***	*5,052*
Premises and equipment	**$*17,672***	$*17,606*
Accumulated depreciation	***(9,451)***	*(8,753)*
Premises and equipment, net	**$*8,221***	$*8,853*

Depreciation expense for the years ended *December 2017, 2016* and *2015* amounted to *$805, $801* and *$749,* respectively. In *December 2017,* the Company sold its Marion branch office and realized a gain on the sale of fixed assets of *$134.*

The Company leases certain branch facilities under noncancellable operating leases. The future minimum lease payments under these leases (with initial or remaining lease terms in excess of *one* year) as of *December 31, 2017* are as follows: *$292* in *2018, $233* in *2019, $56* in *2020, $34* in *2021, $34* in *2022* and *$130* thereafter.

Note *7*: Deposits

The aggregate amounts of time deposits in denominations of *$250* or more at *December 31, 2017* and *2016* were *$14,283* and *$15,797,* respectively. At *December 31, 2017* the scheduled maturities of time deposits are as follows:

2018	***76,378***
2019	***30,124***
2020	***2,224***
2021	***2,931***
2022	***3,227***
Thereafter	**--**
Total time deposits	**$*114,884***

At *December 31, 2017* and *2016,* overdraft demand deposits reclassified to loans totaled *$255* and *$417,* respectively.

Note *8*: Employee Benefit Plans

***401*(k) Plan**

The Company has a Retirement Accumulation Plan qualifying under IRS Code Section *401*(k), in which NBI, NBB and NBFS are participating employers. Eligible participants *may* contribute up to *100%* of their total annual compensation to the plan, subject to certain limits based on federal tax laws. Employee contributions are matched by the employer based on a percentage of an employee's total annual compensation contributed to the plan. For the years ended *December 31, 2017, 2016* and *2015,* the Company contributed *$340, $315* and *$294,* respectively, to the plan.

Employee Stock Ownership Plan

The Company has a non-leveraged Employee Stock Ownership Plan (ESOP) which enables employees of NBI and its subsidiaries who have *one* year of service and who have attained the age of *21* prior to the plan's *January 1* and *July 1* enrollment dates to own NBI common stock. Contributions to the ESOP, which are *not* mandatory, are determined annually by the Board of Directors. Contribution expense amounted to *$200, $150* and *$200* in the years ended *December 31, 2017, 2016* and *2015,* respectively. Dividends on ESOP shares are charged to retained earnings. As of *December 31, 2017,* the number of shares held by the ESOP was *236,221.* All shares held by the ESOP are treated as outstanding in computing the Company's basic net income per share. Upon reaching age *55* with *ten* years of plan participation, a vested participant has the right to diversify *50%* of his or her allocated ESOP shares and NBI or the ESOP, with the agreement of the Trustee, is obligated to purchase those shares. The ESOP contains a put option which allows a withdrawing participant to require the Company or the ESOP, if the plan administrator agrees, to purchase his or her allocated shares if the shares are *not* readily tradable on an established market at the time of distribution.

Table of Contents

Salary Continuation Plan

The Company has a non-qualified Salary Continuation Plan for certain key officers. The plan provides the participating officers with supplemental retirement income, payable for the greater of *15* years after retirement or the officer's lifetime. The expense accrued for the plans in *2017, 2016,* and *2015,* based on the present value of the retirement benefits, amounted to *$272, $242,* and *$396,* respectively. The plan is unfunded. However bank-owned life insurance has been acquired on the life of the key employees in amounts sufficient to discharge the obligations of the agreement.

Defined Benefit Plan

The Company's defined benefit pension plan covers substantially all employees. The plan benefit formula is based upon the length of service of retired employees and a percentage of qualified W-*2* compensation during their final years of employment. Information pertaining to activity in the plan is as follows:

	December 31,		
	2017	**2016**	**2015**
Change in benefit obligation			
Projected benefit obligation at beginning of year	**$*21,059***	$*20,427*	$*19,324*
Service cost	***692***	*694*	*620*
Interest cost	***743***	*757*	*669*
Actuarial loss	***1,417***	*198*	*798*
Benefits paid	***(419)***	*(1,017)*	*(984)*
Projected benefit obligation at end of year	**$*23,492***	$*21,059*	$*20,427*
Change in plan assets			
Fair value of plan assets at beginning of year	**$*17,038***	$*16,131*	$*17,130*
Actual return on plan assets	***2,302***	*1,113*	*(155)*
Employer contribution	***4,507***	*811*	*140*
Benefits paid	***(419)***	*(1,017)*	*(984)*
Fair value of plan assets at end of year	**$*23,428***	$*17,038*	$*16,131*
Funded status at the end of the year	**$*(64)***	$*(4,021)*	$*(4,296)*
Amounts recognized in the Consolidated Balance Sheet			
Deferred tax asset	**$*13***	$*1,407*	$*1,504*
Other liabilities	***(64)***	*(4,021)*	*(4,296)*
Total amounts recognized in the Consolidated Balance Sheet	**$*(51)***	$*(2,614)*	$*(2,792)*
Amounts recognized in accumulated other comprehensive (loss), net			
Net gain (loss)	**$*(7,923)***	$*(8,250)*	$*(8,627)*
Prior service cost	***340***	*449*	*559*
Deferred tax asset	***1,592***	*2,730*	*2,798*
Amount recognized	**$*(5,991)***	$*(5,071)*	$*(5,270)*

Accrued/Prepaid benefit cost, net			
Benefit obligation	**$(23,492)**	$(21,059)	$(20,427)
Fair value of assets	**23,428**	17,038	16,131
Unrecognized net actuarial loss	**7,923**	8,250	8,627
Unrecognized prior service cost	**(340)**	(449)	(559)
Deferred tax liability	**(1,579)**	(1,323)	(1,294)
Prepaid benefit cost included in other assets	**$5,940**	$2,457	$2,478
Components of net periodic benefit cost			
Service cost	**$692**	$694	$620
Interest cost	**743**	757	669
Expected return on plan assets	**(1,097)**	(1,110)	(1,166)
Amortization of prior service cost	**(110)**	(110)	(110)
Recognized net actuarial loss	**540**	572	414
Net periodic benefit cost	**$768**	$803	$427
Other changes in plan assets and benefit obligations recognized in other comprehensive loss			
Net (gain) loss	**$(328)**	$(377)	$1,705
Amortization of prior service cost	**110**	110	110
Deferred income tax expense (benefit)	**46**	93	(635)
Total recognized	**$(172)**	$(174)	$1,180
Total recognized in net periodic benefit cost and other comprehensive loss	**$550**	$536	$2,242
Weighted average assumptions at end of the year			
Discount rate used for net periodic pension cost	**4.00%**	4.00%	3.75%
Discount rate used for disclosure	**3.50%**	4.00%	4.00%
Expected return on plan assets	**7.50%**	7.50%	7.50%
Rate of compensation increase	**3.00%**	3.00%	3.00%

Table of Contents

Long Term Rate of Return

The Company, as plan sponsor, selects the expected long-term rate-of-return-on-assets assumption in consultation with its 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, but higher significance is 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, and 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 Company, as plan sponsor, has adopted a Pension Administrative Committee Policy (the Policy) for monitoring the investment management of its qualified plans. The Policy includes a statement of general investment principles and a listing of specific investment guidelines, to which the committee *may* make documented exceptions. The guidelines state that, unless otherwise indicated, all investments that are permitted under the Prudent Investor Rule shall be permissible investments for the defined benefit pension plan. All plan assets are to be invested in marketable securities. Certain investments are prohibited, including commodities and future contracts, private placements, repurchase agreements, options and derivatives. The Policy establishes quality standards for fixed income investments and mutual funds included in the pension plan trust. The Policy also outlines diversification standards.

The preferred target allocation for the assets of the defined benefit pension plan is *65%* in equity securities and *35%* in fixed income securities. Equity securities include investments in large-cap and mid-cap companies primarily located in the United States, although a small number of international large-cap companies are included. There are also investments in mutual funds holding the equities of large-cap and mid-cap U.S. companies. Fixed income securities include U.S. government agency securities and corporate bonds from companies representing diversified industries. There are *no* investments in hedge funds, private equity funds or real estate.

Table of Contents

Fair value measurements of the pension plan's assets at *December 31, 2017* follow:

	Fair Value Measurements at December 31, 2017			
Asset Category	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Cash	***$4,454***	***$ 4,454***	***$ ---***	***$ ---***
Equity securities:				
U. S. companies	***9,892***	***9,892***	***---***	***---***
International companies	***106***	***106***	***---***	***---***
Equities mutual funds [1]	***1,962***	***1,962***	***---***	***---***
U. S. government agencies and corporations	***51***	***---***	***51***	***---***
State and political subdivisions	***231***	***---***	***231***	***---***
Corporate bonds – investment grade[2]	***6,732***	***---***	***6,732***	***---***
Total pension plan assets	***$23,428***	***$ 16,414***	***$ 7,014***	***$ ---***

(*1*) This category comprises actively managed equity funds invested in large-cap and mid-cap U.S. companies.
(*2*) This category represents investment grade bonds of U.S. issuers from diverse industries.

	Fair Value Measurements at December 31, 2016			
Asset Category	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Cash	*$207*	*$ 207*	$ ---	$ ---
Equity securities:				
U. S. companies	*9,195*	*9,195*	---	---
International companies	*116*	*116*	---	---
Equities mutual funds [1]	*966*	*966*	---	---
U. S. government agencies and corporations	*53*	---	*53*	---
State and political subdivisions	*230*	---	*230*	---
Corporate bonds – investment grade[2]	*6,271*	---	*6,271*	---
Total pension plan assets	*$17,038*	*$ 10,484*	*$ 6,554*	$ ---

(*1*) This category comprises actively managed equity funds invested in large-cap and mid-cap U.S. companies.
(*2*) This category represents investment grade bonds of U.S. issuers from diverse industries.

The Company's required minimum pension contribution for *2018* has *not* yet been determined.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

2018	**$*4,229***
2019	**$*1,060***
2020	**$*1,630***
2021	**$*738***
2022	**$*1,277***
2023 - *2027*	**$*6,546***

Table of Contents

Note *9*: Stock Option Plan

The Company's *1999* Stock Option Plan was adopted in *1999* and was terminated on *March 9, 2009.* Incentive stock options were granted annually to key employees of NBI and its subsidiaries from *1999* to *2005* and *none* have been granted since *2005.* All stock options granted under the plan have been exercised or expired.

There were *no* shares available for exercise during *2017* or *2016.* In *2015,* there were *7,500* shares exercised with an intrinsic value of *$54.* Intrinsic value is the difference between the price at which the shares *may* be exercised and the stock price as of the report date. *No* tax benefit was recognized on shares exercised in *2015.*

Note *10*: Income Taxes

The Company files United States federal income tax returns, and Virginia, West Virginia and North Carolina state income tax returns. 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 *2014.*

Allocation of income tax expense between current and deferred portions is as follows:

	Years ended December 31,		
	2017	**2016**	**2015**
Current	***$2,943***	*$3,934*	*$4,730*
Deferred expense	***1,790***	*18*	*10*
Deferred tax adjustment for enacted change in tax rate	***1,560***	---	---
Total income tax expense	***$6,293***	*$3,952*	*$4,740*

Income tax expense for *2017* includes a downward adjustment of net deferred tax assets in the amount of *$1,560* recorded as a result of the enactment of the Tax Cuts and Jobs Act on *December 22, 2017.* The Company's marginal tax rate prior to the enactment of the Act is *35%.* Effective *January 1, 2018,* the Company's tax rate will be *21%.*

The following is a reconciliation of the "expected" income tax expense, computed by applying the U.S. Federal income tax rate of *35%* to income before income tax expense, with the reported income tax expense:

	Years ended December 31,		
	2017	**2016**	**2015**
Computed “expected” income tax expense	**$*7,135***	$*6,613*	$*7,201*
Tax impact of enacted change in tax rate	***1,560***	---	---
Tax-exempt interest income	***(2,144)***	*(2,234)*	*(2,381)*
Nondeductible interest expense	***89***	*92*	*101*
Other, net	***(347)***	*(519)*	*(181)*
Reported income tax expense	**$*6,293***	$*3,952*	$*4,740*

Table of Contents

The components of net deferred tax assets, included in other assets, are as follows:

	December 31,	
	2017	**2016**
Deferred tax assets:		
Allowance for loan losses and unearned fee income	**$*1,773***	$*3,347*
Valuation allowance on other real estate owned	***156***	*237*
Defined benefit plan	***1,592***	*2,730*
Deferred compensation and other liabilities	***863***	*1,336*
Discount accretion of securities	***---***	*15*
Net unrealized loss on securities available for sale	***984***	*1,932*
Total deferred tax assets	**$*5,368***	$*9,597*
Deferred tax liabilities:		
Fixed assets	**$*(388)***	$*(620)*
Deposit intangibles	***(1,059)***	*(1,573)*
Defined benefit plan, prepaid portion	***(1,579)***	*(1,345)*
Discount accretion of securities	***(2)***	
Total deferred tax liabilities	***(3,028)***	*(3,538)*
Net deferred tax assets	**$*2,340***	$*6,059*

The Company has determined that a valuation allowance for the gross deferred tax assets is *not* necessary at *December 31, 2017* and *2016.*

Note *11*: Restrictions on Dividends

The Company's principal source of funds for dividend payments is dividends received from its subsidiary bank. For the years ended *December 31, 2017, 2016* and *2015,* dividends received from the subsidiary bank were *$8,141, $9,071* and *$7,930,* respectively. National Bankshares Financial Services provided *$350* in dividends to Bankshares in *2016.*

Substantially all of Bankshares' retained earnings are undistributed earnings of its sole banking subsidiary, which are restricted by various regulations administered by federal bank regulatory agencies. Bank regulatory agencies restrict, without prior approval, the total dividend payments of a bank in any calendar year to the bank's retained net income of that year to date, as defined, combined with its retained net income of the preceding *two* years, less any required transfers to surplus. At *December 31, 2017,* NBB's retained net income, which was free of such restriction, amounted to approximately *$20,820.*

Note *12*: Minimum Regulatory Capital Requirement

The Company (on a consolidated basis) and its subsidiary 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 possible 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 regulators about components, risk weightings, and other factors. Prompt corrective action provisions are *not* applicable to bank holding companies.

The Basel III Capital Rules, a comprehensive capital framework for U.S. banking organizations, became effective for the Company and the Bank on *January 1, 2015 (*subject to a phase-in period continuing through *January 1, 2019* for certain provisions). Basel III Capital Rules established quantitative measures to ensure capital adequacy. The rules set forth minimum amounts and ratios for Common Equity Tier *1* capital (*"CET1"*), Tier *1* capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier *1* capital to adjusted quarterly average assets (as defined).

The Company's and the Bank's *CET1* capital include common stock and related surplus and retained earnings. Basel III Capital Rules provide an option to exclude components of accumulated other comprehensive income (loss) from *CET1* capital. Once made, the election is final and cannot be changed. The Company and the Bank elected to exclude components of accumulated other comprehensive income from *CET1* capital.

Tier *1* Capital includes *CET1* capital and additional Tier *1* capital components. At *December 31, 2017* and *2016,* neither the Company nor the Bank held any additional Tier *1* capital beyond *CET1* capital.

Total capital includes Tier *1* capital and Tier *2* capital. Tier *2* capital for both the Company and the Bank includes the allowance for loan losses.

Table of Contents

Risk-weighted assets at *December 31, 2017* were *$808,690* for the Company and *$805,656* for the Bank. Risk-weighted assets at *December 31, 2016* were *$718,739* for the Company and *$715,294* for the Bank. Management believes, as of *December 31, 2017* and *2016,* that the Company and the Bank met all capital adequacy requirements to which they are subject.

As of *December 31, 2017,* the most recent notifications from the Office of the Comptroller of the Currency categorized the bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier *1* risk-based, Common Equity Tier *1* risk-based and Tier *1* leverage ratios, as set forth in the following tables. There are *no* conditions or events since these notifications that management believes have changed the bank's category. The Company's and the Bank's actual capital amounts and ratios as of *December 31, 2017* and *2016* are also presented in the following tables.

	Actual		**Minimum Capital Requirement[(1)]**		**Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions**	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
December 31, 2017						
Total capital (to risk weighted assets)						
NBI consolidated	***$198,468***	***24.542%***	***$74,804***	***9.250%***	***N/A***	***N/A***
NBB	***195,903***	***24.316%***	***74,523***	***9.250%***	***$80,566***	***10.000%***
Tier 1 capital (to risk weighted assets)						
NBI consolidated	***$190,543***	***23.562%***	***$58,630***	***7.250%***	***N/A***	***N/A***
NBB	***187,978***	***23.332%***	***58,410***	***7.250%***	***$64,452***	***8.000%***
Common Equity Tier 1 capital (to risk weighted assets)						
NBI consolidated	***$190,543***	***23.562%***	***$46,500***	***5.750%***	***N/A***	***N/A***
NBB	***187,978***	***23.332%***	***46,325***	***5.750%***	***$52,368***	***6.500%***
Tier 1 capital (to average assets)						
NBI consolidated	***$190,543***	***15.424%***	***$49,413***	***4.000%***	***N/A***	***N/A***
NBB	***187,978***	***15.254%***	***49,293***	***4.000%***	***$61,616***	***5.000%***

(*1*) Except with regard to the Company's and the Bank's Tier *1* capital to average assets ratio, the minimum capital requirement includes the current phased-in portion of the Basel III Capital Rules capital conservation buffer (*1.25%*) which is added to the minimum capital requirements for capital adequacy purposes. The capital conservation buffer is being phased in through *four* equal annual installments of *.0625%* from *2016* to *2019,* with full implementation in *January 2019 (2.5%*). The Company's and the Bank's capital conservation buffer must consist of additional *CET1* above regulatory minimum requirement. Failure to maintain the prescribed levels would result in limitations on capital distributions and discretionary bonuses to executives.

78

Table of Contents

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016						
Total capital (to risk weighted assets)						
NBI consolidated	$191,006	26.575%	$57,499	8.625%	N/A	N/A
NBB	188,095	26.296%	57,224	8.625%	$71,529	10.000%
Tier 1 capital (to risk weighted assets)						
NBI consolidated	$182,706	25.420%	$43,124	6.625%	N/A	N/A
NBB	179,795	25.136%	42,918	6.625%	$57,224	8.000 %
Common Equity Tier 1 capital (to risk weighted assets)						
NBI consolidated	$182,706	25.420%	$32,343	5.125%	N/A	N/A
NBB	179,795	25.136%	32,188	5.125%	$46,494	6.500 %
Tier 1 capital (to average assets)						
NBI consolidated	$182,706	15.121%	$48,333	4.000%	N/A	N/A
NBB	179,795	14.964%	48,060	4.000%	$60,075	5.000 %

Note *13*: Condensed Financial Statements of Parent Company

Financial information pertaining only to NBI (Parent) is as follows:

Condensed Balance Sheets

	December 31,	
	2017	2016
Assets		
Cash due from subsidiaries	**$*46***	$*74*
Interest-bearing deposits	***503***	*1,310*
Securities available for sale, at fair value	**---**	*163*
Investments in subsidiaries, at equity	***184,336***	*177,150*
Refundable income taxes	***168***	*22*
Other assets	***820***	*561*
Total assets	**$*185,873***	$*179,280*
Liabilities and Stockholders' Equity		
Other liabilities	**$*977***	$*1,017*
Stockholders' equity	***184,896***	*178,263*
Total liabilities and stockholders' equity	**$*185,873***	$*179,280*

79

Table of Contents

Condensed Statements of Income

	Years Ended December 31,		
	2017	**2016**	**2015**
Income			
Dividends from subsidiaries	**$8,141**	$9,421	$7,930
Interest on securities – taxable	**---**	2	3
Realized securities gains, net	**4**	---	---
Other income	**1,018**	987	1,208
Total income	**9,163**	10,410	9,141
Expenses			
Other expenses	**1,986**	1,992	2,051
Income before income tax benefit and equity in undistributed net income of subsidiaries	**7,177**	8,418	7,090
Applicable income tax benefit	**383**	628	210
Income before equity in undistributed net income of subsidiaries	**7,560**	9,046	7,300
Equity in undistributed net income of subsidiaries	**6,532**	5,896	8,533
Net income	**$14,092**	$14,942	$15,833

Condensed Statements of Cash Flows

	Years ended December 31,		
	2017	**2016**	**2015**
Cash Flows from Operating Expenses			
Net income	**$14,092**	$14,942	$15,833
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	**(6,532)**	(5,896)	(8,533)
Amortization of premiums and accretion of discounts, net	**---**	1	1
Depreciation expense	**---**	---	3
Gain on sale of securities	**(4)**	---	---
Loss on disposal of fixed assets	**---**	---	2
Net change in refundable income taxes due from subsidiaries	**(146)**	(223)	106
Net change in other assets	**(156)**	219	(81)
Net change in other liabilities	**(40)**	(227)	128
Net cash provided by operating activities	**7,214**	8,816	7,459
Cash Flows from Investing Activities			
Net change in interest-bearing deposits	**807**	(1,140)	307
Maturities, sales and calls of securities available for sale	**192**	---	---
Maturities and calls of securities held to maturity	**---**	450	---
Capital distribution to subsidiary	**(100)**	---	---
Net cash provided by (used in) investing activities	**899**	(690)	307
Cash Flows from Financing Activities			
Cash dividends paid	**(8,141)**	(8,071)	(7,930)
Exercise of stock options	**---**	---	173
Net cash used in financing activities	**(8,141)**	(8,071)	(7,757)
Net change in cash	**(28)**	55	9
Cash due from subsidiaries at beginning of year	**74**	19	10

Cash due from subsidiaries at end of year	***$46***	*$74*	*$19*

Table of Contents

***Note 14*: Financial Instruments with Off-Balance Sheet Risk**

The Company is a party to financial instruments with off-balance sheet risk 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 interest rate locks. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company *may* require collateral or other security to support the following financial instruments with credit risk.

At *December 31, 2017* and *2016,* financial instruments outstanding whose contract amounts represent credit risk were:

	December 31,	
	2017	**2016**
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	***$161,222***	*$130,252*
Standby letters of credit	***16,351***	*20,499*
Mortgage loans sold with potential recourse	***14,130***	*17,526*

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 Company, 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. Some of these commitments are uncollateralized and do *not* contain a specified maturity date and *may not* be drawn upon to the total extent to which the Company is committed.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a *third* party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Collateral held varies but *may* include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

The Company originates mortgage loans for sale to secondary market investors subject to contractually specified and limited recourse provisions. In *2017,* the Company originated *$13,912* and sold *$14,130* to investors, compared to *$17,090* originated and *$17,526* sold in *2016.* Every contract with each investor contains certain recourse language. In general, the Company *may* be required to repurchase a previously sold mortgage loan if there is major noncompliance with defined loan origination or documentation standards, including fraud, negligence or material misstatement in the loan documents. Repurchase *may* also be required if necessary governmental loan guarantees are canceled or never issued, or if an investor is forced to buy back a loan after it has been resold as a part of a loan pool. In addition, the

Company *may* have an obligation to repurchase a loan if the mortgagor defaults early in the loan term. This potential default period is approximately *twelve* months after sale of a loan to the investor.

At *December 31, 2017,* the Company had locked-rate commitments to originate mortgage loans amounting to approximately *$707* and loans held for sale of *$260.* Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Company does *not* expect any counterparty to fail to meet its obligations.

The Company maintains cash accounts in other commercial banks. The Company had *$14* in deposits with correspondent institutions at *December 31, 2017* that was *not* insured by the Federal Deposit Insurance Corporation.

Note *15*: Concentrations of Credit Risk

The Company does a general banking business, serving the commercial and personal banking needs of its customers. NBB's primary service area is defined as the counties of Montgomery, Giles, Carroll, Grayson, Pulaski, Tazewell, Smyth, Wythe, Roanoke and Washington and the cities of Galax, Radford and Roanoke in southwest Virginia, and Mercer and McDowell counties in West Virginia. For loan purposes, our trade area also includes the Virginia cities of Salem and Bristol and counties of Botetourt and Craig, the southernmost tip of West Virginia adjacent to the counties of Giles, Buchanan, Russell and Bland, the North Carolina counties of Surry and Alleghany, and the Tennessee city of Bristol and counties of Washington and Sullivan. Substantially all of NBB's loans are made in its primary service area. Additionally, the Company occasionally participates in loans in nearby higher growth metropolitan areas. Loans outside of the primary service area are a small percentage of the loan portfolio, are appropriately underwritten and are *not* considered out of trade area exceptions. The ultimate collectability of the bank's loan portfolio and the ability to realize the value of any underlying collateral, if needed, is influenced by the economic conditions of the market area. The Company's operating results are therefore closely correlated with the economic trends within this area.

Commercial real estate as of *December 31, 2017* and *2016* represented approximately *51%* and *52%* of the loan portfolio, at *$340,414* and *$336,457,* respectively. Included in commercial real estate are loans for college housing and professional office buildings that comprised *$247,198* and *$236,552* as of *December 31, 2017* and *2016* respectively, corresponding to approximately *37%* of the loan portfolio at *December 31, 2017* and *36%* of the loan portfolio at *December 31, 2016.* Loans secured by residential real estate were *$166,965,* or approximately *25%* of the portfolio, and *$157,718,* or *24%* of the portfolio at *December 31, 2017* and *2016,* respectively.

Table of Contents

The Company has established operating policies relating to the credit process and collateral in loan originations. Loans to purchase real and personal property are generally collateralized by the related property and with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of collateral and the evaluation of the creditworthiness of the individual borrower or project based on available financial information. Management considers the concentration of credit risk to be minimal.

Note *16*: Fair Value Measurements

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. Accounting guidance for fair value excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented *may not* necessarily represent the underlying fair value of the Company.

The Company records fair value adjustments to certain assets and liabilities and determines fair value disclosures utilizing a definition of fair value of assets and liabilities that states that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Additional considerations are involved to determine the fair value of financial assets in markets that are *not* active.

The Company uses a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. The *three* levels of the fair value hierarchy based on these *two* types of inputs are as follows:

Level *1* –	Valuation is based on quoted prices in active markets for identical assets and liabilities.
Level *2* –	Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
Level *3* –	Valuation is based on model-based techniques that use *one* or more significant inputs or assumptions that are unobservable in the market.

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 consider observable market data (Level *2*). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following tables present the balances of financial assets measured at fair value on a recurring basis as of *December 31, 2017* and *2016:*

Description	**Balance as of December 31, 2017**	**Fair Value Measurements at December 31, 2017 Using Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
U.S. Government agencies and corporations	**$*307,719***	**$---**	**$ *307,719***	**$ ---**
States and political subdivisions	***16,834***	***---***	***16,834***	***---***
Mortgage-backed securities	***659***	***---***	***659***	***---***
Corporate debt securities	***6,175***	***---***	***6,175***	***---***
Total securities available for sale	**$*331,387***	**$---**	**$ *331,387***	**$ ---**

Table of Contents

Description	Balance as of December 31, 2016	Fair Value Measurements at December 31, 2016 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agencies and corporations	$ *285,598*	$---	$ *285,598*	$ ---
States and political subdivisions	*11,693*	---	*11,693*	---
Mortgage-backed securities	*930*	---	*930*	---
Corporate debt securities	*5,898*	---	*5,898*	---
Other securities	*163*	---	*163*	---
Total securities available for sale	$ *304,282*	$---	$ *304,282*	$ ---

Certain financial 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 financial 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, 2017* and *2016.*

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 will *not* be collected according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan’s balance exceeds fair value, the amount is allocated to the allowance for loan

losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The fair value of an impaired loan and measurement of associated loss is based on *one* of *three* methods: the observable market price of the loan, the present value of projected cash flows, or the fair value of the collateral. The observable market price of a loan is categorized as a Level *1* input. The present value of projected cash flows method results in a Level *3* categorization because the calculation relies on the Company's judgment to determine projected cash flows, which are then discounted at the current rate of the loan, or the rate prior to modification if the loan is a troubled debt restructure.

Loans measured using the fair value of collateral method *may* be categorized in Level *2* or Level *3.* Collateral *may* be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of *$250* or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of *$100* or greater and secured by *one* piece of collateral. Collateral-method impaired loans with principal balances below *$100,* or if secured by multiple pieces of collateral, below *$250,* are valued using an evaluation.

The value of real estate collateral is determined by a current (less than *12* months of age) appraisal or internal evaluation utilizing an income or market valuation approach. Appraisals conducted by an independent, licensed appraiser outside of the Company using observable market data is categorized as Level *2.* If a current appraisal cannot be obtained prior to a reporting date and an existing appraisal is discounted to obtain an estimated value, or if declines in value are identified after the date of the appraisal, or if an appraisal is discounted for estimated selling costs, the valuation of real estate collateral is categorized as Level *3.* Valuations derived from internal evaluations are categorized as Level *3.* The value of business equipment is based upon an outside appraisal (Level *2*) if deemed significant, or the net book value on the applicable business' financial statements (Level *3*) if *not* considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level *3*).

As of *December 31, 2017* and *December 31, 2016,* the fair value measurements for impaired loans with specific allocations were primarily based upon the present value of expected future cash flows.

Table of Contents

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the period.

Date	Description	Balance	Carrying value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
December 31, 2017	Impaired loans net of valuation allowance	**$ *1,303***	**$---**	**$ ---**	**$ *1,303***
December 31, 2016	Impaired loans net of valuation allowance	*878*	---	---	*878*

The following table presents information about Level *3* Fair Value Measurements for impaired loans.

Impaired Loans	Valuation Technique	Unobservable Input	Range (Weighted Average)
December 31, 2017	Present value of cash flows	Discount rate	*5.50%-13.25%(5.92%)*
December 31, 2016	Present value of cash flows	Discount rate	*6.75%-8.00% (7.35%)*

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. Valuation of other real estate owned is determined using current appraisals from independent parties, a level *two* input. If current appraisals cannot be obtained prior to reporting dates, or if declines in value are identified after a recent appraisal is received, appraisal values are discounted, resulting in Level *3* estimates. If the Company markets the property with a realtor, estimated selling costs reduce the fair value, resulting in a valuation based on Level *3* inputs.

The following table summarizes the Company's other real estate owned that were measured at fair value on a nonrecurring basis during the period.

			Carrying Value		

Date	Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
December 31, 2017	Other real estate owned net of valuation allowance	**$ *2,817***	**$---**	**$ ---**	**$ *2,817***
December 31, 2016	Other real estate owned net of valuation allowance	*3,156*	---	---	*3,156*

Table of Contents

The following table presents information about Level *3* Fair Value Measurements for *December 31, 2017.*

	Valuation Technique	Unobservable Input	Rang (Weighted Average)		
Other real estate owned	Discounted appraised value	Selling cost	*2.00%*[1]	*-6.01%*	*(4.72%)*
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	*1.68%*	*-68.33%*	*(11.07%)*

The following table presents information about Level *3* Fair Value Measurements for *December 31, 2016.*

	Valuation Technique	Unobservable Input	Range (Weighted Average)		
Other real estate owned	Discounted appraised value	Selling cost	*2.91%*[1]	*-8.60%*	*(6.48%)*
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	*0%*	*-53.46%*	*(13.66%)*

(*1*) The Company markets other real estate owned both independently and with local realtors. Properties marketed by realtors are discounted by selling costs. Properties that the Company markets independently are *not* discounted by selling costs.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and Due from Bank, and Interest-Bearing Deposits

The carrying amounts approximate fair value.

Securities

The fair values of securities, excluding restricted stock, are determined by quoted market prices or dealer quotes. The fair value of certain state and municipal securities is *not* readily available through market sources other than dealer quotations, so fair value estimates are based on quoted market prices of similar instruments adjusted for differences between the quoted instruments and the instruments being valued. The carrying value of restricted securities

approximates fair value based upon the redemption provisions of the applicable entities.

Loans Held for Sale

Fair values of loans held for sale are based on commitments on hand from investors or prevailing market prices.

Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate – commercial, real estate – construction, real estate – mortgage, credit card and other consumer loans. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan, as well as estimates for prepayments. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified, as required, by an estimate of the effect of economic conditions on lending.

Fair value for significant nonperforming loans is based on estimated cash flows which are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are determined within management's judgment, using available market information and specific borrower information.

Bank-Owned Life Insurance

Bank-owned life insurance represents insurance policies on officers of the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates fair value.

Deposits

The fair value of demand and savings deposits is the amount payable on demand. The fair value of fixed maturity term deposits and certificates of deposit is estimated using the rates currently offered for deposits with similar remaining maturities.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are *not* deemed significant at *December 31, 2017* and *2016,* and, as such, the related fair values have *not* been estimated.

Table of Contents

The estimated fair values, and related carrying amounts, of the Company's financial instruments are as follows:

	December 31, 2017			
		Estimated Fair Value		
	Carrying Amount	**Level 1**	**Level 2**	**Level 3**
Financial assets:				
Cash and due from banks	**$*12,926***	**$*12,926***	**$---**	**$---**
Interest-bearing deposits	***51,233***	***51,233***	***---***	***---***
Securities	***458,551***	***---***	***461,500***	***---***
Restricted securities	***1,200***	***---***	***1,200***	***---***
Mortgage loans held for sale	***260***	***---***	***260***	***---***
Loans, net	***660,144***	***---***	***---***	***656,399***
Accrued interest receivable	***5,297***	***---***	***5,297***	***---***
Bank-owned life insurance	***33,756***	***---***	***33,756***	***---***
Financial liabilities:				
Deposits	**$*1,059,734***	**$---**	**$*944,850***	**$*113,053***
Accrued interest payable	***62***	***---***	***62***	***---***

	December 31, 2016			
		Estimated Fair Value		
	Carrying Amount	**Level 1**	**Level 2**	**Level 3**
Financial assets:				
Cash and due from banks	$*13,974*	$*13,974*	$---	$---
Interest-bearing deposits	*80,268*	*80,268*	*---*	*---*
Securities	*439,239*	*---*	*441,974*	*---*
Restricted securities	*1,170*	*---*	*1,170*	*---*
Mortgage loans held for sale	*478*	*---*	*478*	*---*
Loans, net	*639,452*	*---*	*---*	*658,386*
Accrued interest receivable	*5,260*	*---*	*5,260*	*---*
Bank-owned life insurance	*22,998*	*---*	*22,998*	*---*
Financial liabilities:				
Deposits	$*1,043,442*	$---	$*912,828*	$*128,690*
Accrued interest payable	*55*	*---*	*55*	*---*

Table of Contents

Note *17*: Components of Accumulated Other Comprehensive Income (Loss)

The following table summarizes the activity related to each component of accumulated other comprehensive income (loss):

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2014	$ *(1,582)*	$ *(4,090)*	$ *(5,672)*
Unrealized holding loss on available for sale securities net of tax of ($571)	*(1,064)*	---	*(1,064)*
Reclassification adjustment, net of tax of ($12)	*(21)*	---	*(21)*
Net pension loss arising during the period, net of tax of ($597)	---	*(1,108)*	*(1,108)*
Less amortization of prior service cost included in net periodic pension cost, net of tax of ($38)	---	*(72)*	*(72)*
Balance at December 31, 2015	$ *(2,667)*	$ *(5,270)*	$ *(7,937)*
Unrealized holding loss on available for sale securities net of tax of ($431)	*(800)*	---	*(800)*
Reclassification adjustment, net of tax of ($65)	*(121)*	---	*(121)*
Net pension gain arising during the period, net of tax of $132	---	*271*	*271*
Less amortization of prior service cost included in net periodic pension cost, net of tax of ($38)	---	*(72)*	*(72)*
Balance at December 31, 2016	$ *(3,588)*	$ *(5,071)*	$ *(8,659)*
Unrealized holding gain on available for sale securities net of tax of $296	*546*	---	*546*
Reclassification adjustment, net of tax of ($4)	*(6)*	---	*(6)*
Net pension gain arising during the period, net of tax of $115	---	*213*	*213*
Less amortization of prior service cost included in net periodic pension cost, net of tax of ($38)	---	*(71)*	*(71)*
Reclassification of stranded tax effects from change in tax rate	*(656)*	*(1,062)*	*(1,718)*
Balance at December 31, 2017	**$ *(3,704)***	**$ *(5,991)***	**$ *(9,695)***

The following table provides information regarding reclassifications out of accumulated other comprehensive income (loss) for the years ended *December 31, 2017, 2016* and *2015:*

	December 31,		
	2017	2016	2015
Component of Accumulated Other Comprehensive Income (Loss)			
Reclassification out of unrealized gains and losses on available-for-sale securities:			
Realized securities gain, net	**$*(10)***	$*(186)*	$*(33)*
Income tax benefit	***(4)***	*(65)*	*(12)*

Realized gain on available-for-sale securities, net of tax, reclassified out of accumulated other comprehensive income (loss)	**$(6)**	$(121)	$(21)
Amortization of defined benefit pension items:			
Prior service costs[1]	**$(109)**	$(110)	$(110)
Income tax benefit	**(38)**	(38)	(38)
Amortization of defined benefit pension items, net of tax, reclassified out of accumulated other comprehensive income (loss)	**$(71)**	$(72)	$(72)

(1) This accumulated other comprehensive income (loss) component is included in the computation of net periodic benefit cost. (For additional information, see Note 8, "Employee Benefit Plans.")

Table of Contents

Note *18*. Intangible Assets and Goodwill

In accounting for goodwill and intangible assets, the Company conducts an impairment review at least annually and more frequently if certain impairment indicators are evident. Accounting guidance provides the option of performing a preliminary assessment of qualitative factors before performing more substantial testing for impairment. If the preliminary assessment indicates that it is more likely than *not* that fair value is below carrying value, a *two*-step test is employed to determine impairment. The Company opted *not* to perform the preliminary assessment and employed the *two*-step test to determine impairment. Based on the testing for impairment of goodwill and intangible assets, there were *no* impairment charges for *2017, 2016* or *2015.*

Information concerning goodwill and intangible assets for years ended *December 31, 2017* and *2016* is presented in the following table:

	Gross Carrying Value	**Accumulated Amortization**	**Net Carrying Value**
December 31, 2017			
Amortizable core deposit intangibles	**$ *16,257***	**$ *16,207***	**$ *50***
Unamortizable goodwill	***5,848***	***---***	***5,848***
Intangible assets and goodwill	**$ *22,105***	**$ *16,207***	**$ *5,898***
December 31, 2016			
Amortizable core deposit intangibles	$ *16,257*	$ *16,139*	$ *118*
Unamortizable goodwill	*5,848*	---	*5,848*
Intangible assets and goodwill	$ *22,105*	$ *16,139*	$ *5,966*

As of *December 31, 2017,* the estimated amortization expense of core deposit intangibles are as follows:

2018	*50*
Thereafter	---
Total	$*50*

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors

National Bankshares, Inc.

Blacksburg, Virginia

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of National Bankshares, Inc. and its subsidiaries (the Company) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2017, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 14, 2018 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

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

We have served as the Company's auditor since 2000.

Winchester, Virginia

March 14, 2018

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors

National Bankshares, Inc.

Blacksburg, Virginia

Opinion on the Internal Control Over Financial Reporting

We have audited National Bankshares, Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2017, and the related notes to the consolidated financial statements of the Company and our report dated March 14, 2018 expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying *Management's Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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

Winchester, Virginia

March 14, 2018

Table of Contents

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of December 31, 2017 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the year ended December 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Because of the inherent limitations in all control systems, the Company believes that no system of controls, no matter how well designed and operated, can provide absolute assurance that all control issues have been detected.

Internal Control Over Financial Reporting

Management's Report on Internal Control Over Financial Reporting

To the Stockholders of National Bankshares, Inc.:

Management is responsible for the preparation and fair presentation of the financial statements included in this annual report. 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 effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting includes those policies and procedures that pertain to the Company's ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the Company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2017. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations (COSO, 2013) of the Treadway Commission. Based on this assessment, management believes the Company maintained effective internal control over financial reporting as of December 31, 2017.

The Board of Directors, acting through its Audit Committee, is responsible for the oversight of the Company's accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent registered public accounting firm and approves decisions regarding the appointment or removal of the Company Auditor. It meets periodically with management, the independent registered public accounting firm and the internal auditors to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the Company in addition to reviewing the Company's financial reports. The independent registered public accounting firm and the internal auditors have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee. The Company's independent registered public accounting firm has also issued an attestation report on the effectiveness of internal control over financial reporting.

Table of Contents

Item 9B. Other Information

None.

Part III

Item 10. Directors, Executive Officers and Corporate Governance

Executive Officers of the Company

The following is a list of names and ages of all executive officers of Bankshares; their terms of office as officers; the positions and offices within Bankshares held by each officer; and each person's principal occupation or employment during the past five years.

Name	Age	Offices and Positions Held	Year Elected an Officer/Director
James G. Rakes [1]	73	National Bankshares, Inc.: Chairman, 1986 to Present; Chairman, President and Chief Executive Officer 1986 through August 31, 2017. The National Bank of Blacksburg: Executive Chairman of the National Bank of Blacksburg, July 2014 through August 31, 2017; President and Chief Executive Officer of The National Bank of Blacksburg from 1983 to July 2014; and Chairman from 2005 to July 2014.	1986
F. Brad Denardo [2]	65	National Bankshares Financial Services: Chairman, President and CEO of National Bankshares Financial Services, Inc., June 2011 to August 31, 2017; Chairman, President and Treasurer, 2001 to June 2011. National Bankshares, Inc.: President and Chief Executive Officer, September 1, 2017 to present; Executive Vice President, 2008 to August 31, 2017. The National Bank of Blacksburg: Chairman, September 2017 to Present; President & CEO, July 2014 to Present; Executive Vice President/Chief Operating Officer, 2002 to July 2014. National Bankshares Financial Services, Inc.: Chairman, President and CEO of National Bankshares Financial Services, Inc., September 1, 2017 to	1989

		Present; Treasurer, June 2011 to Present. National Bankshares, Inc.: Treasurer and Chief Financial Officer, January 2009 to Present.	
David K. Skeens	51	The National Bank of Blacksburg: Senior Vice President/Operations & Risk Management & CFO, 2009 to Present; Senior Vice President/Operations & Risk Management, 2008-2009; Vice President/Operations & Risk Management, 2004-2008. National Bankshares, Inc.: Corporate Secretary, June 1, 2016 to Present.	2009
Lara E. Ramsey	49	National Bankshares, Inc.: Senior Vice President/Administration, June 2011 to Present.	2016
Paul M. Mylum	51	National Bankshares, Inc.: Vice President/Human Resources, January 2001 – June 2011. The National Bank of Blacksburg: Senior Vice President/Chief Lending Officer, August 2016 to Present. The National Bank of Blacksburg: Senior Vice President/Loans, August 2012—August 2016.	2012
Mark A. Smith	56	The National Bank of Blacksburg: Senior Vice President/Chief Credit Officer, April 2016 to Present.	2016

(1) On August 31, 2017, James G. Rakes retired as President and Chief Executive Officer of NBI, Executive Chairman of the National Bank of Blacksburg and Chairman, and President and Chief Executive Officer of National Bankshares Financial Services, Inc. Mr. Rakes continues as Chairman of NBI.

(2) As of September 1, 2017, F. Brad Denardo became the President and Chief Executive Officer of NBI and Chairman, President and CEO of The National Bank of Blacksburg.

Information with respect to the directors of Bankshares is set out under the caption “Election of Directors” of Bankshares’ Proxy Statement for the 2018 Annual Meeting of Stockholders to be held on May 8, 2018 (“Proxy Statement”) which information is incorporated herein by reference.

The Board of Directors of Bankshares has a standing audit committee made up entirely of independent directors, as that term is defined in the NASDAQ Stock Market Listing Rules. In 2017, Dr. Lewis chaired the Audit Committee and its members were Mr. Ball, Dr. Dooley, Mr. Rakes (after his retirement on August 31, 2017), Mr. Reynolds and Mr. Webb. Each member of the Audit Committee has extensive business experience; however, the Committee has identified Dr. Lewis as its financial expert, since he has a professional background which involves financial oversight responsibilities. Dr. Lewis oversaw the preparation of financial statements in his past role as President of New River Community College. He previously served as the College’s Chief Financial Officer. The Audit Committee’s Charter is available on the Company’s web site at www.nationalbankshares.com.

The Board of Directors of Bankshares has a Board Risk Committee tasked with setting a risk tolerance and overseeing risks and risk management throughout the Company. In response to the cybersecurity incidents experienced in 2016 and 2017, the Board of Directors and Board Risk Committee increased their oversight of cybersecurity risk, including receiving monthly updates in greater detail and providing direction for incident response and ongoing capital investment to mitigate risk.

Certain information required by Item 10 is incorporated herein by reference to the Company's Proxy under the headings "Election of Directors", "Stock Ownership of Directors and Executive Officers", "Section 16(a) Beneficial Ownership Reporting Compliance", "Corporate Governance Matters" and "Code of Ethics". The Company and each of its subsidiaries have adopted codes of ethics for directors, officers and employees, specifically including the Chief Executive Officer and Chief Financial Officer of Bankshares. These Codes of Ethics are available on the Company's web site at www.nationalbankshares.com.

Item 11. Executive Compensation

The information required by Item 11 is incorporated herein by reference to the information that appears under the headings "Compensation Discussion and Analysis." "Compensation Committee Interlocks and Insider Participation," and "Compensation Committee Report" in the Company's Proxy Statement for the Annual Meeting of Shareholders.

Pay Ratio Disclosure. The SEC has adopted amendments to Item 402 of Regulation S-K to require disclosure of: (1) the median compensation amount of the annual total compensation of all employees of a registrant excluding the Principal Executive Officer ("PEO"), (2) the annual total compensation of that registrant's PEO and (3) the ratio of the median of the annual total compensation of all employees (excluding the PEO) to the annual total compensation of the PEO. The rules require such pay ratio disclosure information for the first fiscal year beginning on or after January 1, 2017.

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

The information required by Item 12 is incorporated herein by reference to the information that appears under the heading "Stock Ownership of Directors and Executive Officers" in the Company's Proxy Statement for the Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

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

The information required by Item 13 is incorporated herein by reference to the information that appears under the headings "Directors Independence and Certain Transactions with Officers and Directors" and "Election of Directors – Director Independence" in the Company's Proxy Statement for the Annual Meeting of Shareholders. As of December 31, 2017 there were no shares available for issuance or exercise, and there are no equity compensation plans in effect.

Item 14. Principal Accounting Fees and Services

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading “Independent Public Accountants” in the Company’s Proxy Statement for the Annual Meeting of Shareholders.

Table of Contents

Part IV

Item 15. Exhibits, Financial Statement Schedules

(a) (1) Financial Statements

The following consolidated financial statements of National Bankshares, Inc. are included in Item 8:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets – As of December 31, 2017 and 2016

Consolidated Statements of Income – Years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Comprehensive Income – Years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Changes in Stockholders' Equity – Years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Cash Flows – Years ended December 31, 2017, 2016 and 2015

Notes to Consolidated Financial Statements

(a) (2) Financial Statement Schedules

Certain schedules to the consolidated financial statements have been omitted if they were not required by Article 9 of Regulation S-X or if, under the related instructions, they were inapplicable, or if the information is contained elsewhere in this Annual Report on Form

10-K.

(a) (3) Exhibits

A list of the exhibits filed or incorporated in this Annual Report by reference is as follows:

Exhibit No.	Description	Page No. in Sequential System
3(i)		

	Amended and Restated Articles of Incorporation of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	Amended By-laws of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3(ii) of the Form 8K filed on July 9, 2014)
4	Specimen copy of certificate for National Bankshares, Inc. common stock	(incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)
*10(i)	National Bankshares, Inc. 1999 Stock Option Plan	(incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999)
*10(ii)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015)
*10(iii)	Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg	(incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002)
*10(iv)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015)
*10(v)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vi)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vii)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(viii)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)

Table of Contents

*10(ix)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)
*10(x)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xi)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on June 12, 2008)
*10(xii)	Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)
*10(xiii)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xiv)	Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)
*10(xv)	Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xvi)	Salary Continuation Agreement dated May 24, 2013 between The National Bank of Blacksburg and Paul A. Mylum	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 8, 2018)
*10(xvii)	Second Salary Continuation Agreement dated July 1, 2016 between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on July 20, 2016)
*10(xviii)	Salary Continuation Agreement dated February 6, 2006 between The National Bankshares, Inc. and Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xix)	First Amendment, dated December 19, 2007, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xx)	Second Amendment, dated June 12, 2008, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of

		the Form 8K filed on March 6, 2017)
*10(xxi)	Third Amendment, dated June 22, 2016, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
+21	Subsidiaries of the Registrant	Included herein
+23	Consent of Young, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8	(incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2017)
+31(i)	Section 906 Certification of Chief Executive Officer	Included herein
+31(ii)	Section 906 Certification of Chief Financial Officer	Included herein
+32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	Included herein
+32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	Included herein
+101	The following materials from National Bankshares, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2017, formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Changes in Shareholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Consolidated Financial Statements.	Included herein

*Indicates a management contract or compensatory plan required to be filed herein.

+Filed with this Annual Report on Form 10-K.

Item 16. Summary Information

Not applicable.

Table of Contents

Signatures

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

NATIONAL BANKSHARES, INC.

/s/ F. BRAD DENARDO
F. Brad Denardo

President and Chief Executive Officer

(Principal Executive Officer)

/s/ DAVID K. SKEENS
David K. Skeens

Treasurer and Chief Financial Officer

(Principal Financial Officer)

(Principal Accounting Officer)

Date: March 14, 2018

	Date	Title
/s/ L. J. BALL L. J. Ball	03/14/2018	Director
/s/ F. B. DENARDO F. B. Denardo	03/14/2018	President and CEO, National Bankshares, Inc. Director
/s/ J. E. DOOLEY J. E. Dooley	03/14/2018	Director
/s/ M.E. DYE M. E. Dye	03/14/2018	Director
/s/ N. V. FITZWATER, III N. V. Fitzwater, III	03/14/2018	Director
/s/ C. E. GREEN, III C. E. Green, III	03/14/2018	Director

/s/ M. R. JOHNSON M. R. Johnson	03/14/2018	Director
/s/ J. M. LEWIS J. M. Lewis	03/14/2018	Director
/s/ M. G. MILLER M. G. Miller	03/14/2018	Director
/s/ W. A. PEERY W. A. Peery	03/14/2018	Director
/s/ J. G. RAKES J. G. Rakes	03/14/2018	Chairman of the Board, National Bankshares, Inc. Director
/s/ G. P. REYNOLDS G. P. Reynolds	03/14/2018	Director
/s/ J. C. THOMPSON J. C. Thompson	03/14/2018	Director
/s/ J. L. WEBB J. L. Webb	03/14/2018	Director

Table of Contents

Index of Exhibits

The following exhibits are filed with this Annual Report on Form 10-K.

Exhibit No.	Title	Page Number
21	Subsidiaries of the Registrant	Page 96
23	Consent of Yount, Hyde & Barbour, P.C.	Page 97
31(i)	Section 906 Certification of Chief Executive Officer	Page 98
31(ii)	Section 906 Certification of Chief Financial Officer	Page 99
32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	Page 100
32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	Page 101