NATIONAL BANKSHARES INC
Form 10-K
March 08, 2017
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, 2016

[ ] 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 or a smaller reporting company. See definition of "accelerated filer, large accelerated filer, and smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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, 2016 (the last business day of the most recently completed second fiscal quarter) was approximately $242,972,452. As of March 8, 2017, 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. 2016 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2017 Annual Meeting of Stockholders	Part III

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-K

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<u>Part I</u>

$ in thousands, except per share data

<u>Item 1.</u> <u>Business</u>

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 had also been 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-five branch offices throughout southwest Virginia and one loan production office in Roanoke Virginia. NBB has telephone and internet banking and it operates twenty-five automated teller machines in its service area.

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. Each loan category requires underwriting and documentation suited to unique characteristics and inherent risks.

The Bank’s loan policy is updated and approved by the Board of Directors annually, and disseminated throughout the Bank 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 are predominantly non-residential in nature, and include retail centers, 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 "DSC" ratio) is required to be 110% 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 borrower, and guarantees from other parties. The Bank requires title insurance, fire, and 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.

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 with mortgage insurance. 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 yearly 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 interest-only consumer mortgage loans, sub-prime loans, or any variation on subprime lending including hybrid loans and payment option ARMs, or any product with negative amortization. Sub-prime loans involve extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. 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.

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 automobile 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. Although an applicant's creditworthiness is the primary consideration, 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, travelers checks, utility payment services and automatic funds transfer. NBB conducts a general trust business that has wealth management, and trust and estate services for individual and business customers.

At December 31, 2016, NBB had total assets of $1,230,498 and total deposits of $1,043,598. NBB's net income for 2016 was $15,158, which produced a return on average assets of 1.26% and a return on average equity of 8.49%. 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.

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, 2016, 2015 and 2014.

Period	**Class of Service**	**Percentage of Total Revenues**	
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	%
December 31, 2014	Interest and Fees on Loans	58.53	%
	Interest on Investments	23.79	%
	Noninterest Income	17.19	%

Market Area

The Company’s market area in southwest Virginia is made up of the counties of Montgomery, 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. State support for public colleges and universities, like Virginia Tech and Radford University, has been adversely affected by the recession and State budget considerations. 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 all represented. 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. Pulaski and Galax have in the past been centers for furniture manufacturing. However, this industry has been declining because of growing furniture imports and the loss of demand. Several furniture companies have gone out of business in the recent past. 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 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.

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.

At December 31, 2016, NBI employed 15 full time employees, NBB had 210 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, has 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. In the current environment, the potential for additional laws and regulations that will impact the Company, as well as heightened examination standards with regard to asset quality, cannot be ruled out. 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.

The Sarbanes-Oxley Act. The Sarbanes-Oxley Act ("SOX") enacted major reforms of the federal securities laws intended to 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. The Federal Reserve has adopted risk-based capital guidelines that are applicable to NBI. The guidelines provide that the Company must maintain a minimum ratio of 8% of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit) and a minimum ratio of Tier 1 capital to risk-weighted assets of 6%. In addition, the Federal Reserve has established minimum leverage ratio guidelines of 4% for banks that meet certain specified criteria. The leverage ratio is the ratio of Tier 1 capital to total average assets, less intangibles. 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.

On July 2, 2013, the Federal Reserve voted to adopt final Basel III capital rules for U.S. banking organizations. The final rules establish an integrated regulatory capital framework and will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rule, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the final rule includes a new minimum ratio of common equity tier 1 capital (Tier I Common) to risk-weighted assets and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets and includes a minimum leverage ratio of 4% for all banking organizations. These new minimum capital ratios became effective for the Company on January 1, 2015 and will be fully phased-in on January 1, 2019.

The final rule emphasizes common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The final rule also improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets. We continue to monitor the impact of the Basel III final rule on the Company's regulatory capital ratios.

Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for a financial institution 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. 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. Among the provisions of the Dodd-Frank Act that directly impact the Company is the creation of 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 is 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 will coordinate 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. The CFPB has begun implementing mortgage lending regulations to carry out its mandate. In addition, the Federal Reserve issued new rules, effective October 1, 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.

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 (“OCC”). NBB’s deposits are insured by the Federal Deposit Insurance Corporation (“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. 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 is also required to 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. 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. 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, 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.

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 issued a final rule on January 10, 2013 (effective on January 10, 2014), amending 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. 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, 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 2017 annual meeting of stockholders are also posted on a separate website at www.nationalbanksharesproxy.com.

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	72	National Bankshares, Inc.: Chairman, President and Chief Executive Officer. The National Bank of Blacksburg: Executive Chairman of The National Bank of Blacksburg, July 2014 to Present; President and Chief Executive Officer of The National Bank of Blacksburg from 1983 to July 2014; and Chairman from 2005 to July 2014. National Bankshares Financial Services: Chairman, President and CEO of National Bankshares Financial Services, Inc., June 2011 to Present; Chairman, President and Treasurer, 2001 to June 2011.	1986
David K. Skeens	50	National Bankshares, Inc.: Treasurer and Chief Financial Officer, January 2009 to Present. 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.	2009

(continued)

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		National Bankshares, Inc.: Executive Vice President, 2008 to Present.	
F. Brad Denardo	64	The National Bank of Blacksburg: President & CEO, July 2014 to Present; Executive Vice President/Chief Operating Officer, 2002 to July 2014.	1989
		National Bankshares Financial Services, Inc.: Treasurer, June 2011 to Present. National Bankshares, Inc.: Secretary & Counsel, July 2011 through June 1, 2016. The National Bank of Blacksburg: Counsel, May 2011 through June 1, 2016.	
Bryson J. Hunter(1)	49	National Bankshares Financial Services, Inc.: Secretary & Counsel, June 2011 through June 1, 2016. Gentry Locke Rakes & Moore, LLP: Partner, 2008 to 2011.	2011
		National Bankshares, Inc.: Corporate Secretary, June 1, 2016 to Present.	
Lara E. Ramsey	48	National Bankshares, Inc.: Senior Vice President/Administration, June 2011 to Present.	2016
		National Bankshares, Inc.: Vice President/Human Resources, January 2001 through June 2011	

(1) Employment terminatedJune 1, 2016.

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 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. 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 remain low. When market interest rates rise farther, 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, because 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. Until economic and market conditions improve, 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.

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 that already have been 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 or require that we offer unprofitable 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.

The regulatory environment has caused financial industry regulators to impose additional requirements, such as higher capital limits, 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 in 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 operations and the Company’s business strategy. The Company has invested in accepted technologies, and annually reviews 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 and infrastructure may 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 Company experienced two cyber-intrusions, one in May 2016 and one in January 2017 in which certain customer information was compromised. 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.

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 has implemented a 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.

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 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.

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. 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.

Federal and state support for public colleges and universities in the Company’s market area has been adversely affected by the recession and budgetary considerations. As a result, 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.

Changes in accounting standards could impact reported earnings.

The authorities that 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. 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 the 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. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods.

The marginal tax rate applicable to the Company, as with all entities subject to federal income tax, is based on the Company’s taxable income. If the Company’s taxable income declines such that the Company’s marginal tax rate declines, the change in deferred income tax assets and liabilities would result in an expense during the period that a lower marginal tax rate occurs. If changes in tax rates and laws are enacted, the company will recognize the changes in the period in which they occur. Changes in tax rates and laws could impair the Company’s deferred tax assets and result in an expense associated with the change in deferred tax assets and liabilities.

Item 1B. Unresolved Staff Comments

There are no unresolved staff comments.

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 eighteen 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.

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, 2016, there were 684 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 2016 and 2015.

Common Stock Market Prices

	2016		**2015**		**Dividends per share**	
	High	**Low**	**High**	**Low**	**2016**	**2015**
First Quarter	**$35.10**	**$31.75**	$30.98	$28.00	**$---**	$---
Second Quarter	**37.10**	**32.32**	31.36	27.48	**0.55**	0.53
Third Quarter	**37.49**	**33.18**	32.00	29.29	**---**	---
Fourth Quarter	**45.35**	**34.00**	36.76	30.25	**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 11, 2016, 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 2016, there were no shares repurchased, and 100,000 shares may yet be purchased under the program.

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, 2011. These comparisons assume the investment of $100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2011, and the reinvestment of dividends.

	2011	2012	2013	2014	2015	2016
NATIONAL BANKSHARES, INC.	100	120	141	121	146	185
NASDAQ COMPOSITE INDEX	100	118	165	190	203	221
NASDAQ BANK INDEX	100	119	171	177	192	266

Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries

Selected Consolidated Financial Data

$ in thousands, except per share data	**Year ended December 31,**				
	2016	**2015**	**2014**	**2013**	**2012**
Selected Income Statement Data:					
Interest income	**$40,930**	$42,914	$43,944	$45,670	$48,118
Interest expense	**4,166**	4,183	4,899	5,955	7,887
Net interest income	**36,764**	38,731	39,045	39,715	40,231
Provision for loan losses	**1,650**	2,009	1,641	1,531	3,134
Noninterest income	**9,932**	9,486	9,120	9,222	9,278
Noninterest expense	**26,152**	25,635	24,432	24,299	23,383
Income taxes	**3,952**	4,740	5,178	5,317	5,245
Net income	**14,942**	15,833	16,914	17,790	17,747
Per Share Data:					
Basic net income	**2.15**	2.28	2.43	2.56	2.56
Diluted net income	**2.15**	2.28	2.43	2.55	2.55
Cash dividends declared	**1.16**	1.14	1.13	1.12	1.10
Book value	**25.62**	24.74	23.93	21.00	21.60
Selected Balance Sheet Data at End of Year:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**639,452**	610,711	597,203	587,463	583,813
Total securities	**440,409**	389,288	385,385	347,109	350,117
Total assets	**1,233,942**	1,203,519	1,158,798	1,114,561	1,107,964
Total deposits	**1,043,442**	1,018,859	982,428	960,036	946,766
Stockholders' equity	**178,263**	172,114	166,303	145,892	150,109
Selected Balance Sheet Daily Averages:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**613,366**	611,554	584,857	577,746	579,817
Total securities	**420,915**	379,805	361,028	362,334	337,545
Total assets	**1,206,745**	1,155,594	1,120,848	1,090,703	1,080,351
Total deposits	**1,013,787**	976,597	957,684	933,482	925,986
Stockholders' equity	**180,047**	171,732	157,832	149,491	147,812
Selected Ratios:					

Return on average assets	**1.24**	**%**	1.37	%	1.51	%	1.63	%	1.64	%
Return on average equity	**8.30**	**%**	9.22	%	10.72	%	11.90	%	12.01	%
Dividend payout ratio	**54.02**	**%**	50.09	%	46.43	%	43.74	%	43.04	%
Average equity to average assets	**14.92**	**%**	14.86	%	14.08	%	13.71	%	13.68	%
Efficiency ratio[1]	**52.17**	**%**	49.41	%	47.08	%	45.99	%	43.77	%

(1) The efficiency ratio is calculated by dividing noninterest expense by noninterest income and net interest income on a fully taxable equivalent basis.

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 and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 ("EESA") 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 State 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.

Cyber Security Risks and Incidents

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 to provide the Company with recommendations concerning its systems and procedures, which the Company adopted and implemented. The January 2017 intrusion is still under investigation, and a separate independent nationally recognized firm has been retained to conduct this investigation.

The financial impact of the attacks include the amount of the theft, as well as costs of investigation and remediation and any associated litigation. The theft of funds totaled $570 in the May 2016 attack and $1,838 in the January 2017 attack. The Company has insurance coverage for cyber-attack incidents. The extent to which the insurance will cover the Company's loss has not yet been determined, due to the ongoing investigation of the January intrusion and the claims process which is underway for both events. The costs of litigation for both attacks and the cost of investigation and remediation for the January 2017 attack cannot yet be reasonably or accurately estimated. As of December 31, 2016, the Company has appropriately accounted for the May 2016 breach.

We rely on 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.

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 that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained 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.

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 eminent 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 incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value.

Internal evaluations are prepared 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, tax values, 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. For loans that are not collateral dependent and that are not considered uncollectible, the impairment loss is 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 also evaluated, with standard allocations applied consistently to relevant classes.

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, 2016 considered market and portfolio conditions during 2016 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended December 31, 2016. If the economy experiences a downturn, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 4 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

Goodwill and Core Deposit Intangibles

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 2016. 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.

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 intangible assets arising from branch transactions over their useful life. 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.

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.

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-six 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, 2016 and December 31, 2015:

	12/31/16	**12/31/15**
Return on average assets	**1.24 %**	1.37 %
Return on average equity	**8.30 %**	9.22 %
Basic net earnings per common share	**$ 2.15**	$ 2.28
Fully diluted net earnings per common share	**$ 2.15**	$ 2.28
Net interest margin (1)	**3.51 %**	3.86 %
Noninterest margin (2)	**1.36 %**	1.40 %

(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, 2016 was 1.24%, a decrease from 1.37% for the year ended December 31, 2015. The return on average equity decreased from 9.22% for the year ended December 31, 2015 to 8.30% for the year ended December 31, 2016.

Reflecting both the effects of the low interest rate environment throughout 2016 on NBI's yields and funding costs and the Company's asset/liability management practices, the net interest margin decreased from 3.86% at year-end 2015 to 3.51% at December 31, 2016.

The noninterest margin improved from 1.40% to 1.36% over the same period, while basic net earnings per common share decreased from $2.28 for the year ended December 31, 2015 to $2.15 for the year ended December 31, 2016.

Growth

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

	12/31/16	12/31/15
Securities	**$440,409**	$389,288
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**639,452**	610,711
Deposits	**1,043,442**	1,018,859
Total assets	**1,233,942**	1,203,519

Total assets experienced growth in 2016, funded by increases in customer deposits. Customer deposits grew $24,583 or 2.41% from December 31, 2015, 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 $28,741 or 4.71%. Securities increased by $51,121 or 13.13%.

In both 2016 and 2015, 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:

	12/31/16	12/31/15
Nonperforming loans[1]	**$ 5,855**	$ 6,682
Loans past due 90 days or more and accruing	**63**	156
Other real estate owned	**3,156**	4,165
Allowance for loan losses to loans[2]	**1.28 %**	1.34 %
Net charge-off ratio	**0.26 %**	0.32 %

(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, 2016, nonperforming loans were $5,855 or 0.90% of loans net of unearned income and deferred fees and costs. This compares to $6,682 and 1.08% at December 31, 2015. Loans past due 90 days or more and still accruing at year-end 2016 totaled $63, a decrease of $93 or 59.62%, from $156 at December 31, 2015. The net charge-off ratio decreased from 0.32% for the year ended December 31, 2015 to 0.26% for the year ended December 31, 2016, while other real estate owned decreased $1,009 for the same period.

The Company's risk analysis determined an allowance for loan losses of $8,300 at December 31, 2016, resulting in a provision for the year of $1,650. This compares with an allowance for loan losses of $8,297 as of December 31, 2015, and a provision of $2,009 for the year ended December 31, 2015. The ratio of the allowance for loan losses to loans decreased to 1.28%, from 1.34% at December 31, 2015. 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, 2016 was $36,764, a decrease of $1,967, or 5.08%, when compared to the prior year. The net interest margin for 2016 was 3.51%, compared to 3.86% for 2015. Total interest income for the period ended December 31, 2016 was $40,930, a decrease of $1,984 from the period ended December 31, 2015. Interest expense declined by $17 during the same time frame, from $4,183 for the year ended December 31, 2015 to $4,166 for the year ended December 31, 2016. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates. 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.

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, 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 2015, which positively affected the yield on the Company's interest-bearing deposits in other banks for 2016. The yield on interest-bearing deposits increased from 0.26% for 2015 to 0.52% for 2016. The Federal Reserve increased the target fed funds rate by another 25 basis points in December 2016 and the Company expects some benefit in 2017. However, the interest rate environment during 2016 is still considered to be relatively low. In 2016 the Company experienced a large number of calls on higher-yielding securities that were replaced with securities at lower market rates.

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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 that 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.

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, 2016			**December 31, 2015**			**December 31, 2014**		
	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)	**$622,239**	**$29,993**	**4.82 %**	$620,547	$31,122	5.02 %	$593,327	$31,592	5.32 %
Taxable securities(5)	**280,842**	**5,910**	**2.10 %**	234,398	6,776	2.89 %	215,872	6,798	3.15 %
Nontaxable securities (1)(5)	**139,429**	**7,932**	**5.69 %**	147,895	8,425	5.70 %	157,421	9,018	5.73 %
Interest-bearing deposits	**102,819**	**532**	**0.52 %**	96,677	254	0.26 %	103,320	262	0.25 %
Total interest-earning assets	**$1,145,329**	**$44,367**	**3.87 %**	$1,099,517	$46,577	4.24 %	$1,069,940	$47,670	4.46 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	**$568,916**	**$3,144**	**0.55 %**	$526,682	$2,916	0.55 %	$501,956	$3,385	0.67 %
Savings deposits	**94,226**	**34**	**0.04 %**	85,940	34	0.04 %	78,778	35	0.04 %
Time deposits	**180,301**	**988**	**0.55 %**	204,146	1,233	0.60 %	230,418	1,479	0.64 %

Total interest-bearing liabilities	**$843,443**	**$4,166**	**0.49 %**	$816,768	$4,183	0.51 %	$811,152	$4,899	0.60 %
Net interest income[1] and interest rate spread		**$40,201**	**3.38 %**		$42,394	3.73 %		$42,771	3.86 %
Net yield on average interest-earning assets			**3.51 %**			3.86 %			4.00 %

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 0.35% in the three years presented.
(2) Loan fees of $360 in 2016, $448 in 2015 and $407 in 2014 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, 2016	2015	2014
Net interest income, fully taxable equivalent basis	**$40,201**	$42,394	$42,771
Less: taxable equivalent adjustment	**(3,437)**	(3,663)	(3,726)
Net interest income	**$36,764**	$38,731	$39,045

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).

	2016 Over 2015 Changes Due To			2015 Over 2014 Changes Due To		
	Rates(2)	**Volume(2)**	**Net Dollar Change**	**Rates(2)**	**Volume(2)**	**Net Dollar Change**
Interest income: (1)						
Loans	$(1,214)	$ 85	$(1,129)	$(1,882)	$ 1,412	$(470)
Taxable securities	(2,055)	1,189	(866)	(581)	559	(22)
Nontaxable securities	(11)	(482)	(493)	(50)	(543)	(593)
Interest-bearing deposits	261	17	278	9	(17)	(8)
Increase (decrease) in income on interest-earning assets	$(3,019)	$ 809	$(2,210)	$(2,504)	$ 1,411	$(1,093)
Interest expense:						
Interest-bearing demand deposits	$(5)	$ 233	$228	$(630)	$ 161	$(469)
Savings deposits	(3)	3	---	(4)	3	(1)
Time deposits	(108)	(137)	(245)	(84)	(162)	(246)
Increase (decrease) in expense of interest-bearing liabilities	$(116)	$ 99	$(17)	$(718)	$ 2	$(716)
Increase (decrease) in net interest income	$(2,903)	$ 710	$(2,193)	$(1,786)	$ 1,409	$(377)

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2016, 2015 and 2014.
(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.

Total interest expense declined by $17, while interest income on a taxable-equivalent basis decreased $2,210, resulting in a decrease of $2,193 in taxable-equivalent net interest income when 2016 and 2015 are compared. Declining rates impacted net interest income by $2,903, offset by increases due to favorable changes in volume of $710.

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. The continued low interest rate environment resulted in a large number of called securities during 2016 and reduced the opportunity to reinvest the proceeds in securities with more attractive yields. Because of low yields in the securities markets and a highly competitive loan environment, the Company priced deposits accordingly.

Interest on time deposits declined $245 from 2015 to 2016, with a decline of $108 due to rates and $137 due to decreased volume. See "Net Interest Income" for additional information related to the decline in interest expense.

The low interest rate environment was also present in 2015 and 2014. As compared with 2014, there was a $246 decline in interest expense associated with time deposits in 2015. Of the total decline, $84 was due to rates, and $162 stemmed from lower deposit volume. Management focused on deposit pricing and took advantage of falling rates to lower interest expense.

From 2014 to 2015 interest on loans decreased by $470. Reduced rates contributed $1,882 to the decline, partially offset by an increase of $1,412 due to increased volume. As compared with 2014, there was a decrease of $377 in net interest income in 2015, with an increase due to volume of $1,409, offset by declines due to rate of $1,786.

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, 2016 and 2015. 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**	
	2016	**2015**	**2016**	**2015**
300	**1.23 %**	1.57 %	**8.37 %**	10.54%
200	**1.24 %**	1.54 %	**8.42 %**	10.37%
100	**1.24 %**	1.51 %	**8.45 %**	10.20%
(-)100	**1.13 %**	1.36 %	**7.70 %**	9.18 %
(-)200	**1.05 %**	1.32 %	**7.20 %**	8.91 %
(-)300	**1.12 %**	1.34 %	**7.57 %**	9.05 %

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, 2016	**December 31, 2015**	**December 31, 2014**
Service charges on deposits	**$2,458**	$ 2,250	$ 2,434
Other service charges and fees	**212**	215	187
Credit card fees	**3,798**	3,861	3,631
Trust fees	**1,346**	1,229	1,213
Bank-owned life insurance income	**597**	603	616
Other income	**1,289**	1,295	1,037
Realized securities gains	**232**	33	2
Total noninterest income	**$9,932**	$ 9,486	$ 9,120

Service charges on deposit accounts totaled $2,458 for the year ended December 31, 2016. This is an increase of $208, or 9.24%, from $2,250 for the year ended December 31, 2015. Service charges on deposit accounts decreased $184, or 7.56%, from 2014 to 2015. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2016 increase resulted primarily from an increase of $224 in non-sufficient funds and overdraft fees due to implementation of a new overdraft privilege program. The 2015 decline resulted primarily from a decrease of $186 non-sufficient funds and overdraft fees due to a decline in volume.

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 $212 for the year ended December 31, 2016, a decrease of $3, or 1.40%, from the $215 for 2015. The total for the year ended December 31, 2015 was $28 above the $187 posted for the year ended December 31, 2014. The change from 2014 to 2015 is primarily due to improved check sales.

Credit card fees for the year ended December 31, 2016, were $63 below the $3,861 reported for the year ended December 31, 2015. From 2014 to 2015, credit card fees increased $230, or 6.33%. Credit card fees are dependent on the volume of transactions.

Trust fees at $1,346 increased by $117 or 9.52% when the years ended December 31, 2016 and 2015 are compared. For the year ended December 31, 2015 trust fees were $1,229, an increase of $16, or 1.32%, from 2014. 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 2015 and 2016.

Noninterest income from bank-owned life insurance (BOLI) decreased, from $603 for the year ended December 31, 2015 to $597 for 2016. BOLI income for the year ended December 31, 2014 was $616. 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 2016 was $1,289, a slight decrease of $6, or 0.46%, when compared with $1,295 for the year ended December 31, 2015. The increase from 2014 to 2015 stemmed primarily from an increase in gains on mortgage loans sold of $114 and a vendor signing incentive of $100.

Realized securities net gains for the three years presented were associated with called securities. The Company did not sell any securities in 2016, 2015 or 2014.

Noninterest Expense

	Year Ended December 31, 2016	**December 31, 2015**	**December 31, 2014**
Salaries and employee benefits	**$12,792**	$ 12,522	$ 11,606
Occupancy, furniture and fixtures	**1,849**	1,743	1,703
Data processing and ATM	**2,186**	1,657	1,650
FDIC assessment	**476**	546	533
Credit card processing	**2,782**	2,692	2,593
Intangibles amortization	**257**	999	1,075
Net costs of other real estate owned	**472**	608	369
Franchise taxes	**1,296**	1,288	1,182
Other operating expenses	**4,042**	3,580	3,721
Total noninterest expense	**$26,152**	$ 25,635	$ 24,432

Salary and benefits expense increased $270, or 2.16%, from $12,522 for the year ended December 31, 2015 to $12,792 for 2016. Salary and benefits expense was favorably affected by a $680 reduction in fringe benefits, including a $363 reduction in expense associated with the health insurance reserve. The Company participates in a “self-funded” insurance plan and reserves amounts based on employee health insurance usage and calculated projections. Salary and benefits expense was also favorably affected by a reduction of $171 in BOLI and salary continuation expenses. The reductions were offset by an increase of $695 or 7.70% in employee salaries, which were the result of normal staffing and compensation decisions, and an increase in pension expense of $424. Salary and benefits expense increased $916, or 7.89%, from $11,606 for the year ended December 31, 2014 to $12,522 for 2015. From 2014 to 2015, employee salaries increased $230 or 2.62%, which were the result of normal staffing and compensation decisions. The remaining portion of the increase from 2014 to 2015 stemmed primarily from fringe benefits and other compensation expense. Fringe benefits expense increased $168 from 2014 to 2015. Other compensation expenses, including pension expense, employee stock ownership expense and salary continuation expense increased $449 from 2014 to 2015.

Occupancy, furniture and fixtures expense was $1,849 for the year ended December 31, 2016, an increase of $106, or 6.08%, from the prior year. The increase stemmed from upgrades in security equipment, higher lease expense and building maintenance. The 2015 total was $1,743, an increase of $40, or 2.35%, from the $1,703 reported at year-end 2014. The small increases in 2016 and 2015 are reflective of the Company’s emphasis on containing controllable expenses.

Data processing and ATM expense was $2,186 in 2016, $1,657 in 2015 and $1,650 in 2014. The increase of $529 or 31.93% from 2015 to 2016 was due to increased maintenance expense associated with infrastructure upgrades. Data processing and ATM expense in 2014 benefitted from infrastructure upgrades performed in 2014.

When the years ended December 31, 2016 and December 31, 2015 are compared, the Federal Deposit Insurance Corporation assessment expense decreased $70 or 12.82%. The total expense for 2016 was $476, which compares with $546 for 2015. 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, 2015 increased $13 from $533 for 2014.

Credit card processing expense was $2,782 for the period ended December 31, 2016, an increase of $90, or 3.34% from 2015’s total of $2,692. Credit card processing expense in 2015 increased $99, or 3.82% from 2014. 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.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2016 decreased from 2015 by $742 or 74.27%. The decrease in core deposit intangibles amortization is due to certain core deposit intangibles becoming fully amortized in late 2015 and the first half of 2016. The expense for intangibles amortization decreased $76 from 2014 to 2015.

Net costs of other real estate owned decreased from $608 for the period ended December 31, 2015 to $472 for the year ended December 31, 2016. From 2014 to 2015, net costs of other real estate owned increased $239 from $369. 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 2016, write-downs on other real estate were $268. This compares with $440 in 2015 and $84 in 2014. 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 2016 were $118, compared with $181 in 2015. The Company recorded a loss of $86 on the sale of OREO in 2016 and a gain of $14 for 2015. The Company's market area is showing mixed economic signs, with some favorable indicators and some unfavorable indicators, and we anticipate that there will be additional foreclosures in the near future. The Company currently has loans totaling $321 in process of foreclosure. While some of the loans may be resolved in a manner other than foreclosure, it is likely that some loans will be foreclosed and may result in an associated increase in the costs of other real estate owned.

Franchise taxes were $1,296 for the period ended December 31, 2016 and $1,288 for 2015, an increase of $8 or 0.62%. Franchise tax expense increased $106 in 2015 from $1,182 in 2014. State bank franchise taxes are based upon NBB's total equity, which increased in both 2015 and 2016.

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, 2016, other operating expenses were $4,042. This compares with $3,580 for 2015 and $3,721 for 2014. The $462 increase from 2015 to 2016 was primarily due to recognition of $347 in bankcard losses. The $141 decrease from 2014 to 2015 is the result of changes in several categories of expense, with no one item making a significant contribution to the total.

Income Taxes

Income tax expense for 2016 was $3,952 compared to $4,740 in 2015 and $5,178 in 2014. Tax exempt income is the primary difference between expected and actual income tax expense. The Company's effective tax rates for 2016, 2015 and 2014 were 20.92%, 23.04% and 23.44%, respectively. The Company is subject to the 35% marginal tax rate. 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 determined an allowance for loan losses of $8,300 or 1.28% of loans net of unearned income and deferred fees and costs at December 31, 2016, an increase from $8,297 or 1.34% of loans net of unearned income and deferred fees and costs at December 31, 2015. The determination of the appropriate level for the allowance for loan losses resulted in a provision for loan loss of $1,650 for the twelve months ended December 31, 2016, compared with $2,009 for the twelve months ended December 31, 2015. 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 $9,173 with specific allocations to the allowance for loan losses totaling $25 at December 31, 2016, compared with individually evaluated impaired loans of $15,346 with specific allocations totaling $45 at December 31, 2015. The specific allocation is determined based on criteria particular to each impaired loan.

For collectively evaluated loans, the Company applies to each loan class a historical net charge-off rate, averaged over the most recent 8 quarters, and adjusted for factors that influence credit risk. 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 $8,275 or 1.30% at December 31, 2016. At December 31, 2015, collectively evaluated loans totaled $604,538 on a gross basis and $603,680 net of unearned income and deferred fees and costs, with an allowance of $8,252 or 1.37% of the collectively-evaluated portfolio.

Net charge-offs for the twelve months ended December 31, 2016 were $1,647 or 0.26% of average loans, an improvement from $1,975 or 0.32% for the twelve months ended December 31, 2015. 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's market area experienced some favorable economic signs and some weakening indicators when data at December 31, 2016 are compared with data at December 31, 2015. Personal and business bankruptcies decreased resulting in a lower requirement for the allowance for loan losses. The inventory of new and existing homes decreased substantially. Lower housing inventory is beneficial for the Company’s residential construction customers and reduces credit risk, resulting in a lower requirement for the allowance for loan losses. The competitive, legal and regulatory environments remained at similar levels to those at December 31, 2015 with the same allocation requirement. The Federal Reserve’s increase to the federal funds rate is assessed to slightly increase credit risk, with a corresponding increase to the requirement for the allowance for loan losses. The unemployment rate and residential vacancy rate worsened slightly when data at December 31, 2016 are compared with December 31, 2015, resulting in increased allocations to the allowance at December 31, 2016.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days decreased to 0.39% of total loans at December 31, 2016, from 0.48% at December 31, 2015. Accruing loans past due 90 days or more as a percentage of total loans was 0.01% at December 31, 2016, a decrease from 0.03% at December 31, 2015. Nonaccrual loans decreased to 0.90% of total loans at December 31, 2016, from 1.08% at December 31, 2015. The decreases in past due and nonaccrual loans reduced the required level of the allowance for loan losses.

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 $13,519 at December 31, 2016, an increase from $6,144 at December 31, 2015. Collectively evaluated loans rated classified were $3,052 at December 31, 2016, a decrease from $6,071 at December 31, 2015.

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 decreased by 9.76% from the level at December 31, 2015, however the increase in allocation for one loan class that experienced an increase in high risk loans resulted in a small net increase when the allocation for high risk loans for December 31, 2016 is compared with the allocation for high risk loans for December 31, 2015.

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 the total loan portfolio declined six basis points from December 31, 2015. 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, 2016, 2015 and 2014:

	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

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	2014 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$11,111	$11,019	$10,947	$10,867
Interest expense	1,315	1,295	1,147	1,142
Net interest income	9,796	9,724	9,800	9,725
Provision for loan losses	103	701	356	481
Noninterest income	2,221	2,358	2,258	2,283
Noninterest expense	6,161	6,039	6,115	6,117
Income taxes	1,349	1,233	1,324	1,272
Net income	$4,404	$4,109	$4,263	$4,138
Per Share Data:				
Basic net income per common share	$0.63	$0.59	$0.61	$0.60
Fully diluted net income per common share	0.63	0.59	0.61	0.60
Cash dividends per common share	---	0.55	---	0.58
Book value per common share	22.08	22.57	23.43	23.93

Balance Sheet

On December 31, 2016, the Company had total assets of $1,233,942, an increase of $30,423 or 2.53%, over the total of $1,203,519 on December 31, 2015. For 2016, the growth in assets was entirely internally generated and was not the result of acquisitions. Total assets at December 31, 2015 were up by $45,008, or 3.90%, over the total at December 31, 2014.

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 farm 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.

A. Types of Loans

	December 31,				
	2016	**2015**	**2014**	**2013**	**2012**
Real estate construction	**$36,345**	$48,251	$45,562	$45,925	$50,313
Consumer real estate	**157,718**	143,504	147,039	145,499	143,262
Commercial real estate	**336,457**	309,378	310,762	311,266	304,308
Commercial non real estate	**39,024**	37,571	33,413	31,262	37,349
Public sector and IDA	**45,474**	51,335	41,361	34,220	26,169
Consumer non real estate	**33,528**	29,845	28,182	28,423	31,714
Total loans	**$648,546**	$619,884	$606,319	$596,595	$593,115
Less unearned income and deferred fees	**(794)**	(876)	(853)	(905)	(953)
Total loans, net of unearned income and deferred fees and costs	**$647,752**	$619,008	$605,466	$595,690	$592,162
Less allowance for loans losses	**(8,300)**	(8,297)	(8,263)	(8,227)	(8,349)
Total loans, net	**$639,452**	$610,711	$597,203	$587,463	$583,813

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, 2016			
	< 1 Year	1 – 5 Years	After 5 Years	Total
Commercial non real estate	**$26,530**	**$11,843**	**$651**	**$39,024**
Commercial real estate	**72,623**	**212,094**	**51,740**	**336,457**
Real estate construction	**28,960**	**7,385**	**---**	**36,345**
Total	**128,113**	**231,322**	**52,391**	**411,826**
Less loans with predetermined interest rates	**(24,488)**	**(18,196)**	**(10,492)**	**(53,176)**
Loans with adjustable rates	**$103,625**	**$213,126**	**$41,899**	**$358,650**

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,				
	2016	**2015**	**2014**	**2013**	**2012**
Nonaccrual loans:					
Real estate construction	**$---**	$---	$---	$---	$3,109
Consumer real estate	**253**	14	164	198	612
Commercial real estate	**698**	1,146	3,087	5,383	7,018
Commercial non real estate	**217**	883	748	128	82
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	---	---	23	49
Total nonaccrual loans	**$1,168**	$2,043	$3,999	$5,732	$10,870
Restructured loans (TDR Loans) in nonaccrual					
Real estate construction	**$270**	$718	$---	$---	$123
Consumer real estate	**---**	---	---	201	407
Commercial real estate	**4,390**	3,921	5,288	651	1,142
Commercial non real estate	**24**	---	---	---	479
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**3**	---	---	---	---

Total restructured loans in nonaccrual	**$4,687**	$4,639	$5,288	$852	$2,151
Total nonperforming loans	**$5,855**	$6,682	$9,287	$6,584	$13,021
Other real estate owned, net	**3,156**	4,165	4,744	4,712	1,435
Total nonperforming assets	**$9,011**	$10,847	$14,031	$11,296	$14,456
Accruing loans past due 90 days or more:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**42**	145	82	128	156
Commercial real estate	**---**	---	102	---	---
Commercial non real estate	**---**	---	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**21**	11	23	62	14
Total accruing loans past due 90 days or more	**$63**	$156	$207	$190	$170
Accruing restructured loans:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**877**	962	819	579	80
Commercial real estate	**2,892**	7,645	5,192	5,552	1,886
Commercial non real estate	**---**	207	29	60	39
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	---	---	---	---
Total accruing restructured loans	**$3,769**	$8,814	$6,040	$6,191	$2,005

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

Loan Loss Data Table

	2016	2015	2014
Provision for loan losses	**$1,650**	$2,009	$1,641
Net charge-offs to average net loans	**0.26 %**	0.32 %	0.27 %
Allowance for loan losses to loans, net of unearned income and deferred fees	**1.28 %**	1.34 %	1.36 %
Allowance for loan losses to nonperforming loans	**141.76 %**	124.17 %	88.97 %
Allowance for loan losses to nonperforming assets	**92.11 %**	76.49 %	58.89 %
Nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	**1.38 %**	1.74 %	2.30 %
Nonaccrual loans	**$1,168**	$2,043	$3,999
Restructured loans in nonaccrual status	**4,687**	4,639	5,288
Other real estate owned, net	**3,156**	4,165	4,744
Total nonperforming assets	**$9,011**	$10,847	$14,031
Accruing loans past due 90 days or more	**$63**	$156	$207

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, 2016 were $9,173, of which $5,404 were in nonaccrual status. Impaired loans at December 31, 2015 and 2014 were $15,346 and $15,121, of which $6,532 and $8,794 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans improved from 124.17% in 2015 to 141.76% in 2016. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

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. Where the temporary event is not expected to impact a borrower's ability to repay the debt, and where 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, 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**

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 Made During the 12 Months Ended December 31, 2014

to Borrowers Not Experiencing Financial Difficulty

Modification	**Number of Loans Modified**	**Total Amount Modified**
Rate reductions for competitive purposes	54	$ 22,057
Payment extensions for less than 3 months	206	18,121
Maturity date extensions of more than 3 months and up to 6 months	211	39,411
Maturity date extensions of more than 6 months and up to 12 months	326	12,682
Maturity date extensions of more than 12 months	16	4,796
Advances on non-revolving loans or recapitalization	2	39
Change in amortization term or method	37	16,592
Renewal of expired Home Equity Line of Credit loans to additional 10 years	37	628
Renewal of single-payment notes	305	6,837
Total modifications that do not constitute TDRs	1,194	$ 121,163

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 recognizes that in the current economy levels of unemployment and depressed real estate values have resulted in financial difficulties for some customers. 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.

The Company had $8,456 in TDRs as of December 31, 2016 and $13,453 as of December 31, 2015. Accruing TDR loans amounted to $3,769 at December 31, 2016 compared to $8,814 at December 31, 2015.

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 2016, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $3,042 and that have total principal balances of $2,761 as of December 31, 2016. Some of the Company's restructured loans defaulted during the twelve months ended December 31, 2016. 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 2015, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $3,628 and that had total principal balances of $3,504 as of December 31, 2015. All of the restructured loans that defaulted in 2015 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, 2016

	Total TDR Loans	Accruing Current	Accruing 30-89 Days Past Due	Accruing 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	Accruing Current	Accruing 30-89 Days Past Due	Accruing 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

TDR Delinquency Status as of December 31, 2014

	Total TDR Loans	Accruing Current	Accruing 30-89 Days Past Due	Accruing 90+ Days Past Due	Nonaccrual
Real estate construction	$---	$---	$ ---	$ ---	$ ---
Consumer real estate	819	786	---	33	---
Commercial real estate	10,480	5,192	---	---	5,288
Commercial non real estate	29	29	---	---	---

Public sector and IDA	---	---	---	---	---
Consumer non real estate	---	---	---	---	---
Total TDR Loans	$11,328	$6,007	$ ---	$ 33	$ 5,288

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,				
	2016	**2015**	**2014**	**2013**	**2012**
Average loans, net of unearned income and deferred fees and costs	**$621,654**	$619,745	$592,944	$585,991	$588,170
Allowance for loan losses at beginning of year	**8,297**	8,263	8,227	8,349	8,068
Charge-offs:					
Real estate construction	**29**	---	2	184	640
Consumer real estate	**133**	205	222	256	370
Commercial real estate	**488**	1,114	1,201	64	1,589
Commercial non real estate	**883**	490	89	968	109
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**273**	311	346	348	245
Total loans charged off	**1,806**	2,120	1,860	1,820	2,953
Recoveries:					
Real estate construction	**---**	---	---	44	13
Consumer real estate	**2**	2	---	1	8
Commercial real estate	**83**	49	50	25	---
Commercial non real estate	**10**	1	132	18	2
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**64**	93	73	79	77
Total recoveries	**159**	145	255	167	100
Net loans charged off	**1,647**	1,975	1,605	1,653	2,853
Provision charged to operations	**1,650**	2,009	1,641	1,531	3,134
Allowance for loan losses at end of year	**$8,300**	$8,297	$8,263	$8,227	$8,349
Net charge-offs to average loans net of unearned income and deferred fees and costs	**0.26** %	0.32 %	0.27 %	0.28 %	0.49 %

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.

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, 2016			**2015**			**2014**			**2013**			**2012**		
	Allowance Amount	**Percent of Loans in Each Category to Total Loans**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans**	
Real estate construction	**$438**	**5.60**	**%**	$576	7.78	%	$612	7.52	%	$863	7.70	%	$1,070	8.48	%
Consumer real estate	**1,830**	**24.32**	**%**	1,866	23.15	%	1,662	24.25	%	1,697	24.39	%	2,263	24.15	%
Commercial real estate	**3,738**	**51.88**	**%**	4,109	49.92	%	3,537	51.25	%	3,685	52.17	%	3,442	51.31	%
Commercial non real estate	**1,063**	**6.02**	**%**	655	6.06	%	1,475	5.51	%	989	5.24	%	959	6.30	%
Public sector and IDA	**330**	**7.01**	**%**	436	8.28	%	327	6.82	%	132	5.74	%	142	4.41	%
Consumer non real estate	**644**	**5.17**	**%**	627	4.81	%	602	4.65	%	576	4.76	%	424	5.35	%
Unallocated	**257**			28			48			285			49		
	$8,300	**100.00**	**%**	$8,297	100.00	%	$8,263	100.00	%	$8,227	100.00	%	$8,349	100.00	%

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

	December 31, 2016		**2015**		**2014**	
Impaired loans	**$9,173**		$15,346		$15,121	
Allowance related to impaired loans	**25**		45		282	
Allowance to impaired loans	**0.27**	**%**	0.29	%	1.87	%

Non-impaired loans	**639,373**	604,538	591,198
Allowance related to non-impaired loans	**8,275**	8,252	7,981
Allowance to non-impaired loans	**1.29 %**	1.37 %	1.35 %
Total loans	**648,546**	619,884	606,319
Less: unearned income and deferred fees and costs	**(794)**	(876)	(853)
Loans, net of unearned income and deferred fees and costs	**647,752**	619,008	605,466
Allowance for loan losses, total	**8,300**	8,297	8,263
Allowance as a percentage of loans, net of unearned income and deferred fees and costs	**1.28 %**	1.34 %	1.36 %

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 $25 at December 31, 2016, $45 at December 31, 2015 and $282 at December 31, 2014. 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 $8,275 or 1.30% at December 31, 2016, $8,252 or 1.37% at December 31, 2015, and $7,981 or 1.35% at December 31, 2014. 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 2015 to 2016 due to a decreased charge-off ratio, down from 0.32% for the twelve months ended December 31, 2015 to 0.26% for the year ended December 31, 2016. Also contributing to the reduced allowance requirement were improved asset quality indicators, lower levels of high risk loans and favorable economic indicators. The ratio increased from 2014 due to increases in net charge-offs, accruing loans 30-89 days past due, levels of loans rated "special mention", levels of high-risk loans and certain economic factors, partially offset by positive changes in levels of nonaccrual loans, classified loans and certain other economic factors.

The unallocated portion of the reserve was $257 at December 31, 2016, $28 at December 31, 2015 and $48 at December 31, 2014. 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 $8,300 at December 31, 2016, $8,297 as of December 31, 2015 and $8,263 as of December 31, 2014 indicated provision charges for loan losses of $1,650 for the twelve months ended December 31, 2016, $2,009 for the twelve months ended December 31, 2015 and $1,641 for the twelve months ended December 31, 2014. 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 $304,282, an increase of $68,151 or 28.86% from December 31, 2015. The amortized cost of securities held to maturity was $134,957 at December 31, 2016 and $152,028 at December 31, 2015, a decrease of $17,071 or 11.23%.

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. 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.

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.

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, 2016 and weighted average yield for each range of maturities.

$ in thousands, except percent data	Maturities and Yields December 31, 2016					
	< 1 Year	1-5 Years	5-10 Years	> 10 Years	None	Total
Available for Sale:						
U.S. Government agencies	$1,994	$192,129	$73,416	$18,059	$---	$285,598
	0.78 %	1.37 %	2.02 %	3.44 %	---	1.67 %
Mortgage-backed securities	$---	$191	$223	$516	$---	$930
	---	4.97 %	5.63 %	5.40 %	---	5.38 %
States and political subdivision – nontaxable (1)	$1,429	$3,107	$4,362	$2,795	$---	$11,693
	5.96 %	5.79 %	5.91 %	5.51 %	---	5.79 %
Corporate	$---	$1,006	$---	$4,892	$---	$5,898
	---	2.48 %	---	4.15 %	---	3.88 %
Other securities	$---	$---	$---	$---	$163	$163
	---	---	---	---	---	---
Total	$3,423	$196,433	$78,001	$26,262	$163	$304,282
	2.94 %	1.45 %	2.25 %	3.83 %	---	1.88 %
Restricted stock:						
Restricted stock	$---	$---	$---	$---	$1,170	$1,170
	---	---	---	---	5.21 %	5.21 %
Held to Maturity:						
U.S. Government agencies	$---	$2,999	$---	$935	$---	$3,934
	---	3.75 %	---	3.54 %	---	3.70 %
Mortgage-backed securities	$---	$---	$126	$139	$---	$265
	---	---	5.48 %	5.69 %	---	5.59 %
States and political subdivision – nontaxable (1)	$3,902	$24,275	$16,489	$85,117	$---	$129,783
	6.01 %	6.34 %	5.43 %	5.10 %	---	5.40 %
Corporate	$---	$975	$---	$---	$---	$975
	---	2.40 %	---	---	---	2.40 %
Total	$3,902	$28,249	$16,615	$86,191	$---	$134,957
	6.01 %	5.93 %	5.43 %	5.08 %	---	5.33 %

(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, 2016 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 $24,583 or 2.41%, from $1,018,859 at December 31, 2015 to $1,043,442 at December 31, 2016. Total deposits grew $36,431, or 3.71%, from $982,428 at December 31, 2014 to December 31, 2015. A portion of the increase in both 2016 and 2015 is attributable to a higher level of municipal deposits. The increases in total deposits for 2016 and 2015 were internally generated and not the result of acquisitions.

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,								
	2016			**2015**			**2014**		
	Average Amounts	**Average Rates Paid**		**Average Amounts**	**Average Rates Paid**		**Average Amounts**	**Average Rates Paid**	
Noninterest-bearing demand deposits	**$170,344**	**---**		$159,829	---		$146,532	---	
Interest-bearing demand deposits	**568,916**	**0.55**	**%**	526,682	0.55	%	501,956	0.67	%
Savings deposits	**94,226**	**0.04**	**%**	85,940	0.04	%	78,778	0.04	%
Time deposits	**180,301**	**0.55**	**%**	204,146	0.60	%	230,418	0.64	%
Average total deposits	**$1,013,787**	**0.41**	**%**	$976,597	0.43	%	$957,684	0.60	%

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, 2016				
	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	**$3,488**	**$ 4,298**	**$ 4,959**	**$ 3,052**	**$15,797**

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 $1,225. 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.

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, 2016, 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, 2016, 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, 2016, 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, 2016, 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, 2016, the loan to deposit ratio was 62.08%, 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, 2016, 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	**$169,441**	**$86,765**	**$61,511**	**$20,995**	**$ 170**
Purchase obligations [(1)]	**9,530**	**3,528**	**4,577**	**1,425**	**---**
Operating leases	**1,071**	**292**	**575**	**90**	**164**
Total	**$180,042**	**$90,585**	**$66,613**	**$22,510**	**$ 334**

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

As of December 31, 2016, 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, 2016, 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, 2016 was $178,263, an increase of $6,149, or 3.57%, from the $172,114 at December 31, 2015. The largest component of 2016 stockholders' equity was retained earnings of $178,224, which included net income of $14,942, offset by dividends of $8,071. Total stockholders' equity increased by $5,811 or 3.49%, from $166,303 on December 31, 2014 to $172,114 on December 31, 2015.

Risk based capital ratios are shown in the following tables.

	Ratios at December 31, 2016	Regulatory Capital Minimum Ratios	Regulatory Capital Minimum Ratios with Capital Conservative 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 %**

	Ratios at December 31, 2015	Regulatory Capital Minimum Ratios	Regulatory Capital Minimum Ratios with Capital Conservative Buffer
Common Equity Tier I Capital Ratio	24.376 %	4.500 %	--- %
Tier I Capital Ratio	24.376 %	6.000 %	--- %
Total Capital Ratio	25.527 %	8.000 %	--- %
Leverage Ratio	15.088 %	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, 2016 and December 31, 2015.

Beginning January 1, 2016, a capital conservation buffer of .625% became effective. The capital conservation buffer will be gradually increased through January 1, 2019 to 2.5%. Banks will be required to maintain capital levels that meet the required minimum plus the capital conservation buffer in order to make distributions or discretionary bonus payments.

Off-Balance Sheet Arrangements

The Company’s off-balance sheet arrangements at December 31, 2016 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	**$130,252**	**$130,252**	**$ ---**	**$ ---**	**$ ---**
Standby letters of credit	**20,499**	**20,499**	**---**	**---**	**---**
Mortgage loans with potential recourse	**17,526**	**17,526**	**---**	**---**	**---**
Operating leases	**1,071**	**292**	**525**	**90**	**164**
Total	**$169,348**	**$168,569**	**$ 525**	**$ 90**	**$ 164**

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 $56 in 2016.

While it would be possible for customers to draw in full on approved lines of credit and 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, 2016. 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.

Item 8. **Financial Statements and Supplementary Data**

Consolidated Balance Sheets	**December 31,**	
$ in thousands, except share and per share data	**2016**	**2015**
Assets		
Cash and due from banks	**$13,974**	$12,152
Interest-bearing deposits	**80,268**	130,811
Securities available for sale, at fair value	**304,282**	236,131
Securities held to maturity (fair value of $137,692 at December 31, 2016 and $158,032 at December 31, 2015)	**134,957**	152,028
Restricted stock	**1,170**	1,129
Mortgage loans held for sale	**478**	634
Loans:		
Real estate construction loans	**36,345**	48,251
Consumer real estate loans	**157,718**	143,504
Commercial real estate loans	**336,457**	309,378
Commercial non real estate loans	**39,024**	37,571
Public sector and IDA loans	**45,474**	51,335
Consumer non real estate loans	**33,528**	29,845
Total loans	**648,546**	619,884
Less unearned income and deferred fees and costs	**(794)**	(876)
Loans, net of unearned income and deferred fees and costs	**647,752**	619,008
Less allowance for loan losses	**(8,300)**	(8,297)
Loans, net	**639,452**	610,711
Premises and equipment, net	**8,853**	9,020
Accrued interest receivable	**5,260**	5,769
Other real estate owned, net	**3,156**	4,165
Intangible assets and goodwill	**5,966**	6,224
Bank-owned life insurance (BOLI)	**22,998**	22,401
Other assets	**13,128**	12,344
Total assets	**$1,233,942**	$1,203,519
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	**$171,946**	$166,453
Interest-bearing demand deposits	**605,226**	569,787
Savings deposits	**96,829**	90,236
Time deposits	**169,441**	192,383
Total deposits	**1,043,442**	1,018,859
Accrued interest payable	**55**	56
Other liabilities	**12,182**	12,490
Total liabilities	**1,055,679**	1,031,405
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 2016 and 2015	**8,698**	8,698
Retained earnings	**178,224**	171,353

Accumulated other comprehensive loss, net	**(8,659)**	(7,937)
Total stockholders' equity	**178,263**	172,114
Total liabilities and stockholders' equity	**$1,233,942**	$1,203,519

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

Consolidated Statements of Income

	Years ended December 31,		
$ in thousands, except share and per share data	**2016**	**2015**	**2014**
Interest Income			
Interest and fees on loans	**$29,365**	$30,446	$31,058
Interest on interest-bearing deposits	**532**	254	262
Interest and dividends on securities – taxable	**5,910**	6,776	6,798
Interest on securities – nontaxable	**5,123**	5,438	5,826
Total interest income	**40,930**	42,914	43,944
Interest Expense			
Interest on deposits	**4,166**	4,183	4,899
Total interest expense	**4,166**	4,183	4,899
Net interest income	**36,764**	38,731	39,045
Provision for loan losses	**1,650**	2,009	1,641
Net interest income after provision for loan losses	**35,114**	36,722	37,404
Noninterest Income			
Service charges on deposit accounts	**2,458**	2,250	2,434
Other service charges and fees	**212**	215	187
Credit card fees	**3,798**	3,861	3,631
Trust income	**1,346**	1,229	1,213
BOLI income	**597**	603	616
Other income	**1,289**	1,295	1,037
Realized securities gains, net	**232**	33	2
Total noninterest income	**9,932**	9,486	9,120
Noninterest Expense			
Salaries and employee benefits	**12,792**	12,522	11,606
Occupancy, furniture and fixtures	**1,849**	1,743	1,703
Data processing and ATM	**2,186**	1,657	1,650
FDIC assessment	**476**	546	533
Credit card processing	**2,782**	2,692	2,593
Intangible assets amortization	**257**	999	1,075
Net costs of other real estate owned	**472**	608	369
Franchise taxes	**1,296**	1,288	1,182
Other operating expenses	**4,042**	3,580	3,721
Total noninterest expense	**26,152**	25,635	24,432
Income before income taxes	**18,894**	20,573	22,092
Income tax expense	**3,952**	4,740	5,178
Net income	**$14,942**	$15,833	$16,914
Basic net income per common share	**$2.15**	$2.28	$2.43
Fully diluted net income per common share	**$2.15**	$2.28	$2.43

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

Consolidated Statements of Comprehensive Income

$ in thousands, except share and per share data	Years ended December 31, 2016	2015	2014
Net Income	**$14,942**	$15,833	$16,914
Other Comprehensive Income (Loss), Net of Tax			
Unrealized holding gain (loss) on available for sale securities net of tax of ($431) in 2016, ($571) in 2015 and $6,693 in 2014	**(800)**	(1,064)	12,430
Reclassification adjustment for gain included in net income, net of tax of ($65) in 2016, ($12) in 2015 and ($1) in 2014	**(121)**	(21)	(1)
Net pension gain (loss) arising during the period, net of tax of $132 in 2016, ($597) in 2015 and ($574) in 2014	**271**	(1,108)	(1,066)
Less amortization of prior service cost included in net periodic pension cost, net of tax of ($38) in 2016, ($38) in 2015 and ($39) in 2014	**(72)**	(72)	(71)
Other comprehensive income (loss), net of tax of ($402) in 2016, ($1,218) in 2015 and $6,079 in 2014	**(722)**	(2,265)	11,292
Total Comprehensive Income	**$14,220**	$13,568	$28,206

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity

$ in thousands, except share and per share data	Common Stock	Retained Earnings	Accumulated Other Comprehensive (Loss)	Total
Balance at December 31, 2013	$ 8,685	$ 154,171	$ (16,964)	$ 145,892
Net income	---	16,914	---	16,914
Other comprehensive income, net of tax of $6,079	---	---	11,292	11,292
Cash dividend ($1.13 per share)	---	(7,853)	---	(7,853)
Exercise of stock options	3	55	---	58
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**

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

Consolidated Statements of Cash Flows

	Years Ended December 31,		
$ in thousands, except share and per share data	**2016**	**2015**	**2014**
Cash Flows from Operating Activities			
Net income	**$14,942**	$15,833	$16,914
Adjustment to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	**1,650**	2,009	1,641
Deferred income tax expense	**18**	10	73
Depreciation of premises and equipment	**801**	749	732
Amortization of intangibles	**257**	999	1,075
Amortization of premiums and accretion of discounts, net	**89**	117	138
Loss on disposal of fixed assets	**---**	15	94
Gain on calls of securities available for sale, net	**(186)**	(33)	(2)
Gain on calls of securities held to maturity, net	**(46)**	---	---
Loss and writedown on other real estate owned	**355**	426	129
Income on investment in BOLI	**(597)**	(603)	(616)
Gain on sale of mortgage loans held for sale	**(280)**	(273)	(159)
Origination of mortgage loans held for sale	**(17,090)**	(17,641)	(9,104)
Sale of mortgage loans held for sale	**17,526**	17,571	10,248
Net change in:			
Accrued interest receivable	**509**	(21)	201
Other assets	**(373)**	420	(574)
Accrued interest payable	**(1)**	(12)	(24)
Other liabilities	**(41)**	963	(428)
Net cash provided by operating activities	**17,533**	20,529	20,338
Cash Flows from Investing Activities			
Net change in interest-bearing deposits	**50,543**	(28,263)	(4,482)
Proceeds from repayments of mortgage-backed securities	**415**	717	902
Proceeds from calls and maturities of securities available for sale	**220,581**	64,556	11,088
Proceeds from calls and maturities of securities held to maturity	**16,945**	9,205	8,677
Purchases of securities available for sale	**(290,296)**	(80,093)	(33,905)
Purchases of securities held to maturity	**---**	---	(6,381)
Net change in restricted stock	**(41)**	(40)	325
Purchases of loan participations	**(3,800)**	(1,001)	(200)
Collections of loan participations	**820**	1,978	1,539
Loan originations and principal collections, net	**(27,792)**	(17,259)	(13,880)
Proceeds from disposal of other real estate owned	**877**	773	744
Recoveries on loans charged off	**159**	145	255
Additions to premises and equipment	**(634)**	(663)	(459)
Proceeds from sale of premises and equipment	**---**	---	453
Net cash used in investing activities	**(32,223)**	(49,945)	(35,324)
Cash Flows from Financing Activities			
Net change in time deposits	**(22,942)**	(24,363)	(24,963)

Net change in other deposits	**47,525**	60,794	47,355
Cash dividends paid	**(8,071)**	(7,930)	(7,853)
Stock options exercised	**---**	173	58
Net cash provided by financing activities	**16,512**	28,674	14,597
Net change in cash and due from banks	**1,822**	(742)	(389)
Cash and due from banks at beginning of year	**12,152**	12,894	13,283
Cash and due from banks at end of year	**$13,974**	$12,152	$12,894
Supplemental Disclosures of Cash Flow Information			
Interest paid on deposits and borrowed funds	**$4,167**	$4,195	$4,923
Income taxes paid	**3,940**	4,790	5,282
Supplemental Disclosures of Noncash Activities			
Loans charged against the allowance for loan losses	**$1,806**	$2,120	$1,860
Loans transferred to other real estate owned	**222**	620	905
Unrealized gain (loss) on securities available for sale	**(1,417)**	(1,668)	19,121
Minimum pension liability adjustment	**293**	(1,815)	1,750

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

Notes to Consolidated Financial Statements

$ in thousands, except share data and 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.

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, and 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.

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.

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, 2016, 2015 and 2014.

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 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.

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.

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.

	2016	**2015**	**2014**
Average number of common shares outstanding	**6,957,974**	6,953,849	6,948,789
Effect of dilutive options	**---**	3,245	10,345
Average number of common shares outstanding used to calculate diluted earnings per common share	**6,957,974**	6,957,094	6,959,134

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 2016, 2015 or 2014. As of December 31, 2016, 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 2016, the Company expensed $122, and expensed $105 and $174 in 2015 and 2014, 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 other intangibles, 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.

Certain reclassifications have been made to prior period balances to conform to the current year provisions. Prior to 2016, the Company netted the prepaid asset associated with the defined benefit plan against the net liability for the funded status of the defined benefit plan. The result was a net liability. During 2016, the Company segregated the prepaid pension asset and the net liability. In order to provide comparability in prior periods, assets and liabilities have been adjusted to reflect a separate defined benefit plan asset and liability for each year reported.

Recent Accounting Pronouncements

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to 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 public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

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.

During March 2016, the FASB issued ASU No. 2016-05, “Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.” The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require de-designation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments in this ASU are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-05 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, “Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting.” The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early Adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, "Compensation – Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting." The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

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. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

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 public business entities 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. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. 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.

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.

Note 3: Securities

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

	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**

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Available for sale:	December 31, 2015 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government agencies and corporations	$216,897	$ 519	$ 4,952	$212,464
States and political subdivisions	15,934	541	---	16,475
Mortgage-backed securities	1,199	120	---	1,319
Corporate debt securities	6,015	22	291	5,746
Other securities	189	---	62	127
Total securities available for sale	$240,234	$ 1,202	$ 5,305	$236,131

The amortized cost and fair value of single maturity securities available for sale at December 31, 2016, 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, 2016.

Available for sale:	**December 31, 2016 Amortized Cost**	**Fair Value**
Due in one year or less	**$3,414**	**$3,423**
Due after one year through five years	**199,430**	**196,433**
Due after five years through ten years	**80,548**	**78,001**
Due after ten years	**26,221**	**26,262**
No maturity	**189**	**163**
	$309,802	**$304,282**

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

Held to maturity:	**December 31, 2016 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**

Held to maturity:	**December 31, 2015** **Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Government agencies and corporations	$13,909	$ 288	$ 177	$14,020
States and political subdivisions	136,373	6,179	330	142,222
Mortgage-backed securities	327	36	---	363
Corporate debt securities	1,419	10	2	1,427
Total securities held to maturity	$152,028	$ 6,513	$ 509	$158,032

The amortized cost and fair value of single maturity securities held to maturity at December 31, 2016, 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, 2016.

	December 31, 2016	
	Amortized	**Fair**
Held to maturity:	**Cost**	**Value**
Due in one year or less	**$3,902**	**$3,988**
Due after one year through five years	**28,249**	**29,761**
Due after five years through ten years	**16,615**	**17,155**
Due after ten years	**86,191**	**86,788**
	$134,957	**$137,692**

Information pertaining to securities with gross unrealized losses at December 31, 2016 and 2015 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	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**

	December 31, 2015			
	Less Than 12 Months		**12 Months or More**	
	Fair Value	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U. S. Government agencies and corporations	$88,255	$ 1,800	$84,959	$ 3,329
State and political subdivisions	3,449	24	10,161	306
Corporate debt securities	4,974	292	200	1
Other securities	---	---	127	62
Total temporarily impaired securities	$96,678	$ 2,116	$95,447	$ 3,698

The Company had 325 securities with a fair value of $297,770 that were temporarily impaired at December 31, 2016. The total unrealized loss on these securities was $7,410. Of the temporarily impaired total, 4 securities with a fair value of $2,475 and an unrealized loss of $178 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, 2016 for the reasons set out below.

U.S. Government agencies. The unrealized losses of $4 on US Government agency securities stemmed from 1 security with a fair value of $996. The unrealized loss was 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.

States and political subdivisions. This category exhibits unrealized losses of $148 on 2 securities with a fair value of $1,316. 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.

Other securities. The Company holds a small investment in community bank stock. One security with a fair value of $163 has an unrealized loss of $26. The value of this investment has been negatively affected by market conditions. Because the Company does not intend to sell this investment before recovery of its amortized cost basis, the Company does not consider this investment to be other-than-temporarily impaired.

Restricted stock. The Company holds restricted stock of $1,170 as of December 31, 2016 and $1,129 as of December 31, 2015. 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 $493,620 at December 31, 2016. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at December 31, 2016, 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, 2016 and 2015, securities with a carrying value of $178,121 and $156,721, respectively, were pledged to secure municipal deposits and for other purposes as required or permitted by law.

Realized securities gains and losses. The Company did not sell any securities during 2016, 2015 or 2014. All realized gains and losses resulted from calls of securities. Information pertaining to realized gains and losses on called securities follows:

	For the year ended December 31, 2016				
	Proceeds	**Book Value**	**Gross Gain**	**Gross Loss**	**Net Gain (Loss)**
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 (Loss)**
Available for sale	$63,775	$63,742	$34	$1	$33
Held to maturity	7,605	7,605	---	---	---

	For the year ended December 31, 2014				
	Proceeds	**Book Value**	**Gross Gain**	**Gross Loss**	**Net Gain (Loss)**
Available for sale	$6,919	$6,917	$4	$2	$2
Held to maturity	7,162	7,162	1	1	---

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 advances extended to related parties amounted to $8,754 at December 31, 2016 and $8,819 at December 31, 2015. During the year ended December 31, 2016, total principal additions were $4,966 and principal payments were $5,031. The Company held $14,604 in deposits for related parties as of December 31, 2016 and $11,275 as of December 31, 2015.

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 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 the probability that collection 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.

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. Further, restructured loans are individually evaluated for impairment, with amounts below fair value accrued 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 included 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.

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

Consumer Real Estate

Equity lines

Residential closed-end first liens

Residential closed-end junior liens

Investor-owned residential real estate

Commercial Real Estate

Multifamily real estate

Commercial real estate, owner-occupied

Commercial real estate, other

Commercial Non Real Estate

Commercial and Industrial

Public Sector and IDA

Public sector and IDA

Consumer Non Real Estate

Credit cards

Automobile

Other consumer loans

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.

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 loan officers' average years of experience, the risk from changes in loan review, 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 lending policies, 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.

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, 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

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2014

		Consumer	**Commercial**	**Commercial**	**Public**		**Unallocated**	**Total**

	Real Estate Construction	Real Estate	Real Estate	Non Real Estate	Sector and IDA	Consumer Non Real Estate		
Balance, December 31, 2013	$863	$ 1,697	$ 3,685	$ 989	$ 132	$ 576	$ 285	$8,227
Charge-offs	(2)	(222)	(1,201)	(89)	---	(346)	---	(1,860)
Recoveries	---	---	50	132	---	73	---	255
Provision for loan losses	(249)	187	1,003	443	195	299	(237)	1,641
Balance, December 31, 2014	$612	$ 1,662	$ 3,537	$ 1,475	$ 327	$ 602	$ 48	$8,263

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**
Collectively evaluated for impairment	**36,075**	**156,841**	**328,675**	**38,783**	**45,474**	**33,525**	**---**	**639,373**
Total	**$36,345**	**$157,718**	**$ 336,457**	**$ 39,024**	**$45,474**	**$ 33,528**	**$ ---**	**$648,546**

Allowance for Loan Losses by Segment and Evaluation Method as of 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
Individually evaluated for impairment	$---	$ 22	$ 23	$ ---	$ ---	$ ---	$ ---	$45
Collectively evaluated for impairment	576	1,844	4,086	655	436	627	28	8,252
Total	$576	$ 1,866	$ 4,109	$ 655	$ 436	$ 627	$ 28	$8,297

Loans by Segment and Evaluation Method as of 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
Individually evaluated for impairment	$718	$962	$ 12,575	$ 1,091	$---	$ ---	$ ---	$15,346
Collectively evaluated for impairment	47,533	142,542	296,803	36,480	51,335	29,845	---	604,538
Total	$48,251	$143,504	$ 309,378	$ 37,571	$51,335	$ 29,845	$ ---	$619,884

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

	December 31, 2016	2015
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs	**1.28 %**	1.34 %
Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs	**0.26 %**	0.32 %

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A summary of nonperforming assets follows:

	December 31, 2016	2015
Nonperforming assets:		
Nonaccrual loans	**$1,168**	$2,043
Restructured loans in nonaccrual	**4,687**	4,639
Total nonperforming loans	**5,855**	6,682
Other real estate owned, net	**3,156**	4,165
Total nonperforming assets	**$9,011**	$10,847
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	**1.38 %**	1.74 %
Ratio of allowance for loan losses to nonperforming loans(1)	**141.76%**	124.17%

(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, 2016	2015
Loans past due 90 days or more and still accruing	**$63**	$156
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 %**	0.03 %
Accruing restructured loans	**$3,769**	$8,814
Impaired loans:		
Impaired loans with no valuation allowance	**$8,269**	$12,973
Impaired loans with a valuation allowance	**904**	2,373
Total impaired loans	**$9,173**	$15,346
Valuation allowance	**$(26)**	$(45)
Impaired loans, net of allowance	**$9,147**	$15,301
Average recorded investment in impaired loans(1)	**$11,585**	$17,297
Income recognized on impaired loans, after designation as impaired	**$553**	$769
Amount of income recognized on a cash basis	**$---**	$---

(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, 2016, 2015 or 2014. Nonaccrual loans that meet the Company’s balance thresholds are designated as impaired.

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

	Impaired Loans as of December 31, 2016				
	Principal Balance	(A) 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

	Impaired Loans as of December 31, 2015				
	Principal Balance	(A) 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	Related Allowance

				Allowance	
Real Estate Construction[2]					
Construction 1-4 family residential	$718	$ 718	$ 718	$ ---	$ ---
Consumer Real Estate[2]					
Residential closed-end first liens	713	669	305	364	13
Residential closed-end junior liens	218	218	---	218	5
Investor-owned residential real estate	75	75	---	75	4
Commercial Real Estate[2]					
Multifamily real estate	1,988	1,728	1,728	---	---
Commercial real estate, owner occupied	5,068	5,020	3,304	1,716	23
Commercial real estate, other	5,990	5,827	5,827	---	---
Commercial Non Real Estate[2]					
Commercial and Industrial	1,099	1,091	1,091	---	---
Total	$15,869	$ 15,346	$ 12,973	$ 2,373	$ 45

(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[1]	Interest Income Recognized
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.

Average Investment and Interest Income for

Impaired Loans

For the Year Ended

December 31, 2015

	Average Recorded Investment[1]	Interest Income Recognized
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.

	Average Investment and Interest Income for Impaired Loans For the Year Ended December 31, 2014	
	Average Recorded Investment[1]	Interest Income Recognized
Consumer Real Estate[2]		
Residential closed-end first liens	$ 555	$ 31
Residential closed-end junior liens	249	16
Investor-owned residential real estate	77	5
Commercial Real Estate[2]		
Multifamily real estate		