

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549**

**FORM 10-Q**

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

For the quarterly period ended June 30, 2017

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 0-15204

**NATIONAL BANKSHARES, INC.**

(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of incorporation or organization)

54-1375874  
(I.R.S. Employer Identification No.)

101 Hubbard Street  
P. O. Box 90002  
Blacksburg, VA  
(Address of principal executive offices)

24062-9002  
(Zip Code)

(540) 951-6300  
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company)  
Smaller reporting company  Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange act.  
 Yes  No

Note: the text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.  
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
 Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class  
Common Stock, \$1.25 Par Value

Outstanding at August 3, 2017  
6,957,974

(This report contains 60 pages)

---

**NATIONAL BANKSHARES, INC. AND SUBSIDIARIES**

Form 10-Q

Index

<b><u>Part I – Financial Information</u></b>		<b>Page</b>
Item 1	<a href="#"><u>Financial Statements</u></a>	3
	<a href="#"><u>Consolidated Balance Sheets, June 30, 2017 (Unaudited) and December 31, 2016</u></a>	3
	<a href="#"><u>Consolidated Statements of Income for the Three Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	4 – 5
	<a href="#"><u>Consolidated Statements of Comprehensive Income for the Three Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	6
	<a href="#"><u>Consolidated Statements of Income for the Six Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	7 – 8
	<a href="#"><u>Consolidated Statements of Comprehensive Income for the Six Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	9
	<a href="#"><u>Consolidated Statements of Changes in Stockholders’ Equity for the Six Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	10
	<a href="#"><u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2017 and 2016 (Unaudited)</u></a>	11 – 12
	<a href="#"><u>Notes to Consolidated Financial Statements (Unaudited)</u></a>	13 – 36
Item 2	<a href="#"><u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></a>	36
Item 3	<a href="#"><u>Quantitative and Qualitative Disclosures About Market Risk</u></a>	54
Item 4	<a href="#"><u>Controls and Procedures</u></a>	54
<b><u>Part II – Other Information</u></b>		
Item 1	<a href="#"><u>Legal Proceedings</u></a>	54
Item 1A	<a href="#"><u>Risk Factors</u></a>	54
Item 2	<a href="#"><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></a>	54
Item 3	<a href="#"><u>Defaults Upon Senior Securities</u></a>	54
Item 4	<a href="#"><u>Mine Safety Disclosures</u></a>	54
Item 5	<a href="#"><u>Other Information</u></a>	55
Item 6	<a href="#"><u>Exhibits</u></a>	55
<b><u>Signatures</u></b>		55
<b><u>Index of Exhibits</u></b>		56 – 57
<b><u>Certifications</u></b>		58 – 60

**Item 1. Financial Statements**

**Part I**  
**Financial Information**  
National Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

<b>\$ in thousands, except per share data</b>	<b>(Unaudited)</b> <b>June 30,</b> <b>2017</b>	<b>December 31,</b> <b>2016</b>
<b>Assets</b>		
Cash and due from banks	\$ 12,936	\$ 13,974
Interest-bearing deposits	89,096	80,268
Securities available for sale, at fair value	308,435	304,282
Securities held to maturity (fair value of \$135,297 at June 30, 2017 and \$137,692 at December 31, 2016)	130,712	134,957
Restricted stock, at cost	1,200	1,170
Loans held for sale	491	478
Loans:		
Loans, net of unearned income and deferred fees	654,734	647,752
Less allowance for loan losses	(8,372)	(8,300)
Loans, net	646,362	639,452
Premises and equipment, net	8,557	8,853
Accrued interest receivable	5,139	5,260
Other real estate owned, net	3,008	3,156
Intangible assets and goodwill	5,923	5,966
Bank-owned life insurance	33,287	22,998
Other assets	14,208	13,128
<b>Total assets</b>	<b>\$ 1,259,354</b>	<b>\$ 1,233,942</b>
<b>Liabilities and Stockholders' Equity</b>		
Noninterest-bearing demand deposits	\$ 181,868	\$ 171,946
Interest-bearing demand deposits	618,223	604,093
Savings deposits	140,325	136,789
Time deposits	121,941	130,614
Total deposits	1,062,357	1,043,442
Accrued interest payable	43	55
Other liabilities	12,668	12,182
Total liabilities	1,075,068	1,055,679
Commitments and contingencies		
<b>Stockholders' Equity</b>		
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 at June 30, 2017 and at December 31, 2016	8,698	8,698
Retained earnings	181,546	178,224
Accumulated other comprehensive loss, net	(5,958)	(8,659)
Total stockholders' equity	184,286	178,263
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,259,354</b>	<b>\$ 1,233,942</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands, except per share data</b>	<b>June 30, 2017</b>	<b>June 30, 2016</b>
<b>Interest Income</b>		
Interest and fees on loans	\$ 7,453	\$ 7,289
Interest on interest-bearing deposits	231	150
Interest on securities – taxable	1,397	1,567
Interest on securities – nontaxable	1,214	1,286
Total interest income	10,295	10,292
<b>Interest Expense</b>		
Interest on time deposits	135	181
Interest on other deposits	913	882
Total interest expense	1,048	1,063
Net interest income	9,247	9,229
Provision for loan losses	464	654
Net interest income after provision for loan losses	8,783	8,575
<b>Noninterest Income</b>		
Service charges on deposit accounts	692	569
Other service charges and fees	41	46
Credit and debit card fees	1,019	969
Trust income	361	354
BOLI income	146	151
Other income	192	455
Realized securities gain, net	4	74
Total noninterest income	2,455	2,618
<b>Noninterest Expense</b>		
Salaries and employee benefits	3,438	2,907
Occupancy and furniture and fixtures	469	448
Data processing and ATM	541	595
FDIC assessment	91	145
Credit and debit card processing	725	712
Intangible assets amortization	12	68
Net costs of other real estate owned	55	39
Franchise taxes	329	322
Other operating expenses	1,038	1,002
Total noninterest expense	6,698	6,238
Income before income taxes	4,540	4,955
Income tax expense	970	1,090

*(continued)*

<b>Net Income</b>	\$	<b>3,570</b>	\$	3,865
Basic net income per common share	\$	<b>0.51</b>	\$	0.56
Fully diluted net income per common share	\$	<b>0.51</b>	\$	0.56
Weighted average number of common shares outstanding				
– basic and diluted		<b>6,957,974</b>		6,957,974
Dividends declared per common share	\$	<b>0.56</b>	\$	0.55

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
Three Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands</b>	<b>June 30, 2017</b>	<b>June 30, 2016</b>
Net Income	\$ 3,570	\$ 3,865
<b>Other Comprehensive Income, Net of Tax</b>		
Unrealized holding gain on available for sale securities net of tax of \$874 and \$368 for the periods ended June 30, 2017 and 2016, respectively	1,626	684
Reclassification adjustment for gain included in net income, net of tax of (\$16) for the period ended June 30, 2016	---	(30)
Other comprehensive income, net of tax of \$874 and \$352 for the periods ended June 30, 2017 and 2016, respectively	1,626	654
<b>Total Comprehensive Income</b>	<b>\$ 5,196</b>	<b>\$ 4,519</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Six Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands, except per share data</b>	<b>June 30, 2017</b>	<b>June 30, 2016</b>
<b>Interest Income</b>		
Interest and fees on loans	\$ 14,906	\$ 14,623
Interest on interest-bearing deposits	379	312
Interest on securities – taxable	2,799	3,244
Interest on securities – nontaxable	2,449	2,597
Total interest income	20,533	20,776
<b>Interest Expense</b>		
Interest on time deposits	280	375
Interest on other deposits	1,796	1,756
Total interest expense	2,076	2,131
Net interest income	18,457	18,645
Provision for loan losses	523	857
Net interest income after provision for loan losses	17,934	17,788
<b>Noninterest Income</b>		
Service charges on deposit accounts	1,357	1,129
Other service charges and fees	110	118
Credit and debit card fees	1,917	1,839
Trust income	762	677
BOLI income	289	298
Other income	520	800
Realized securities gain, net	4	98
Total noninterest income	4,959	4,959
<b>Noninterest Expense</b>		
Salaries and employee benefits	6,981	6,475
Occupancy and furniture and fixtures	907	925
Data processing and ATM	1,106	1,006
FDIC assessment	186	286
Credit and debit card processing	1,380	1,334
Intangible assets amortization	43	178
Net costs of other real estate owned	84	108
Franchise taxes	651	653
Other operating expenses	2,297	1,957
Total noninterest expense	13,635	12,922
Income before income taxes	9,258	9,825
Income tax expense	2,039	2,181

*(continued)*

---

<b>Net Income</b>	\$	<b>7,219</b>	\$	7,644
Basic net income per common share	\$	<b>1.04</b>	\$	1.10
Fully diluted net income per common share	\$	<b>1.04</b>	\$	1.10
Weighted average number of common shares outstanding				
– basic and diluted		<b>6,957,974</b>		6,957,974
Dividends declared per common share	\$	<b>0.56</b>	\$	0.55

See accompanying notes to consolidated financial statements.



National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
Six Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands</b>	<b>June 30, 2017</b>	<b>June 30, 2016</b>
Net Income	\$ 7,219	\$ 7,644
<b>Other Comprehensive Income, Net of Tax</b>		
Unrealized holding gain on available for sale securities net of tax of \$1,454 and \$2,170 for the periods ended June 30, 2017 and 2016, respectively	2,701	4,032
Reclassification adjustment for gain included in net income, net of tax of (\$18) for the period ended June 30, 2016	---	(34)
Other comprehensive income, net of tax of \$1,454 and \$2,152 for the periods ended June 30, 2017 and 2016, respectively	2,701	3,998
<b>Total Comprehensive Income</b>	<b>\$ 9,920</b>	<b>\$ 11,642</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity  
Six Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands</b>	<b>Common Stock</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Total</b>
Balances at December 31, 2015	\$ 8,698	\$ 171,353	\$ (7,937)	\$ 172,114
Net income	---	7,644	---	7,644
Dividends \$0.55 per share	---	(3,828)	---	(3,828)
Other comprehensive income, net of tax of \$2,152	---	---	3,998	3,998
<b>Balances at June 30, 2016</b>	<b>\$ 8,698</b>	<b>\$ 175,169</b>	<b>\$ (3,939)</b>	<b>\$ 179,928</b>
Balances at December 31, 2016	\$ 8,698	\$ 178,224	\$ (8,659)	\$ 178,263
Net income	---	7,219	---	7,219
Dividends \$0.56 per share	---	(3,897)	---	(3,897)
Other comprehensive income, net of tax of \$1,454	---	---	2,701	2,701
<b>Balances at June 30, 2017</b>	<b>\$ 8,698</b>	<b>\$ 181,546</b>	<b>\$ (5,958)</b>	<b>\$ 184,286</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Six Months Ended June 30, 2017 and 2016  
(Unaudited)

<b>\$ in thousands</b>	<b>June 30, 2017</b>	<b>June 30, 2016</b>
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 7,219	\$ 7,644
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	523	857
Depreciation of bank premises and equipment	400	393
Amortization of intangibles	43	178
Amortization of premiums and accretion of discounts, net	31	48
Gain on sales and calls of securities available for sale, net	---	(52)
Gain on calls of securities held to maturity, net	(4)	(46)
Loss and write-down on other real estate owned, net	49	55
Increase in cash value of bank-owned life insurance	(289)	(298)
Originations of mortgage loans held for sale	(4,889)	(6,431)
Proceeds from sale of mortgage loans held for sale	4,953	6,508
Gain on sale of mortgage loans held for sale	(77)	(106)
Net change in:		
Accrued interest receivable	121	510
Other assets	(2,534)	(1,307)
Accrued interest payable	(12)	---
Other liabilities	486	(133)
Net cash provided by operating activities	<u>6,020</u>	<u>7,820</u>
<b>Cash Flows from Investing Activities</b>		
Net change in interest-bearing deposits	(8,828)	54,919
Proceeds from calls, principal payments, sales and maturities of securities available for sale	9,334	122,457
Proceeds from calls, principal payments and maturities of securities held to maturity	4,204	13,591
Purchases of securities available for sale	(9,318)	(183,355)
Net change in restricted stock	(30)	(41)
Purchase of BOLI	(10,000)	---
Purchases of loan participations	(672)	(1,446)
Collections of loan participations	743	584
Loan originations and principal collections, net	(7,702)	(12,097)
Proceeds from sales of other real estate owned	196	685
Recoveries on loans charged off	101	92
Proceeds from sale and purchases of premises and equipment, net	(104)	(92)
Net cash used in investing activities	<u>(22,076)</u>	<u>(4,703)</u>

*(continued)*

---

**Cash Flows from Financing Activities**

Net change in time deposits	(8,673)	(11,931)
Net change in other deposits	27,588	14,810
Cash dividends paid	(3,897)	(3,828)
Net cash provided by (used in) financing activities	15,018	(949)
Net change in cash and due from banks	(1,038)	2,168
Cash and due from banks at beginning of period	13,974	12,152
Cash and due from banks at end of period	\$ 12,936	\$ 14,320

**Supplemental Disclosures of Cash Flow Information**

Interest paid on deposits and borrowed funds	\$ 2,088	\$ 2,131
Income taxes paid	2,151	2,250

**Supplemental Disclosure of Noncash Activities**

Loans charged against the allowance for loan losses	\$ 552	\$ 1,051
Loans transferred to other real estate owned	97	---
Unrealized net gain on securities available for sale	4,155	6,150

See accompanying notes to consolidated financial statements.

**National Bankshares, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**June 30, 2017**  
**(Unaudited)**

**\$ in thousands, except per share data**

**Note 1: General**

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (“NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, the “Company”), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the six month period ended June 30, 2017 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company’s 2016 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at [www.nationalbankshares.com](http://www.nationalbankshares.com).

**Note 2:**

**Loan Portfolio**

The loan portfolio, excluding loans held for sale, was comprised of the following.

	June 30, 2017	December 31, 2016
Real estate construction	\$ 34,567	\$ 36,345
Consumer real estate	162,368	157,718
Commercial real estate	331,713	336,457
Commercial non real estate	43,539	39,024
Public sector and IDA	49,533	45,474
Consumer non real estate	33,672	33,528
Gross loans	655,392	648,546
Less unearned income and deferred fees and costs	(658)	(794)
Loans, net of unearned income and deferred fees and costs	<u>\$ 654,734</u>	<u>\$ 647,752</u>

**Note 3: 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 contractual terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as “classified” or “other assets especially mentioned.” Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair value. Impaired loans that are not troubled debt restructures and for which fair value measurement indicates an impairment loss are designated nonaccrual. A restructured loan that maintains current status for at least six months may be in accrual status. Please refer to Note 1 of the Company’s 2016 Form 10-K, “Summary of Significant Accounting Policies” for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

Troubled debt restructures 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 are as follows.

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

#### *Historical Loss Rates*

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

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

#### *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, the interest rate environment, and the competitive, legal and 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 the Company's 2016 10-K, 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, housing 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 for the Six Months Ended June 30, 2017

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2016	\$ 438	\$ 1,830	\$ 3,738	\$ 1,063	\$ 330	\$ 644	\$ 257	\$ 8,300
Charge-offs	---	(138)	(122)	(73)	---	(219)	---	(552)
Recoveries	---	1	36	10	---	54	---	101
Provision for loan losses	(87)	340	116	103	83	218	(250)	523
<b>Balance, June 30, 2017</b>	<b>\$ 351</b>	<b>\$ 2,033</b>	<b>\$ 3,768</b>	<b>\$ 1,103</b>	<b>\$ 413</b>	<b>\$ 697</b>	<b>\$ 7</b>	<b>\$ 8,372</b>

#### Activity in the Allowance for Loan Losses for the Six Months Ended June 30, 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)	(89)	(125)	(708)	---	(100)	---	(1,051)
Recoveries	---	1	59	1	---	31	---	92
Provision for loan losses	(32)	(2)	(574)	1,537	(55)	(3)	(14)	857
<b>Balance, June 30, 2016</b>	<b>\$ 515</b>	<b>\$ 1,776</b>	<b>\$ 3,469</b>	<b>\$ 1,485</b>	<b>\$ 381</b>	<b>\$ 555</b>	<b>\$ 14</b>	<b>\$ 8,195</b>

#### Activity in the Allowance for Loan Losses 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
<b>Balance, December 31, 2016</b>	<b>\$ 438</b>	<b>\$ 1,830</b>	<b>\$ 3,738</b>	<b>\$ 1,063</b>	<b>\$ 330</b>	<b>\$ 644</b>	<b>\$ 257</b>	<b>\$ 8,300</b>

**Allowance for Loan Losses as of June 30, 2017**

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	\$ ---	\$ 22	\$ 1	\$ ---	\$ ---	\$ ---	\$ ---	\$ 23
Collectively evaluated for impairment	351	2,011	3,767	1,103	413	697	7	8,349
<b>Total</b>	<b>\$ 351</b>	<b>\$ 2,033</b>	<b>\$ 3,768</b>	<b>\$ 1,103</b>	<b>\$ 413</b>	<b>\$ 697</b>	<b>\$ 7</b>	<b>\$ 8,372</b>

**Allowance for Loan Losses 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
<b>Total</b>	<b>\$ 438</b>	<b>\$ 1,830</b>	<b>\$ 3,738</b>	<b>\$ 1,063</b>	<b>\$ 330</b>	<b>\$ 644</b>	<b>\$ 257</b>	<b>\$ 8,300</b>

**Loans as of June 30, 2017**

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	\$ 3,300	\$ 1,115	\$ 5,646	\$ 137	\$ ---	\$ 2	\$ ---	\$ 10,200
Collectively evaluated for impairment	31,267	161,253	326,067	43,402	49,533	33,670	---	645,192
<b>Total</b>	<b>\$ 34,567</b>	<b>\$ 162,368</b>	<b>\$ 331,713</b>	<b>\$ 43,539</b>	<b>\$ 49,533</b>	<b>\$ 33,672</b>	<b>\$ ---</b>	<b>\$ 655,392</b>

**Loans 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
<b>Total</b>	<b>\$ 36,345</b>	<b>\$ 157,718</b>	<b>\$ 336,457</b>	<b>\$ 39,024</b>	<b>\$ 45,474</b>	<b>\$ 33,528</b>	<b>\$ ---</b>	<b>\$ 648,546</b>



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

	As of and for the		
	Six Months Ended	Year Ended	
	June 30, 2017	2016	December 31, 2016
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees	1.28%	1.30%	1.28%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees <sup>(1)</sup>	0.14%	0.31%	0.26%

<sup>(1)</sup> Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

	June 30,		December 31,
	2017	2016	2016
Nonperforming assets:			
Nonaccrual loans	\$ 9	\$ 1,751	\$ 1,168
Restructured loans in nonaccrual	3,188	4,454	4,687
Total nonperforming loans	3,197	6,205	5,855
Other real estate owned, net	3,008	3,425	3,156
Total nonperforming assets	\$ 6,205	\$ 9,630	\$ 9,011
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	0.94%	1.52%	1.38%
Ratio of allowance for loan losses to nonperforming loans <sup>(1)</sup>	261.87%	132.07%	141.76%

<sup>(1)</sup> The Company defines nonperforming loans as nonaccrual loans and restructured loans that are nonaccrual. Nonperforming loans do not include loans 90 days past due and still accruing or accruing restructured loans.

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

	June 30,		December 31,
	2017	2016	2016
Loans past due 90 days or more and still accruing	\$ 259	\$ 316	\$ 63
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees	0.04%	0.05%	0.01%
Accruing restructured loans	\$ 3,711	\$ 4,729	\$ 3,769
Impaired loans:			
Impaired loans with no valuation allowance	\$ 9,320	\$ 8,902	\$ 8,269
Impaired loans with a valuation allowance	880	1,798	904
Total impaired loans	\$ 10,200	\$ 10,700	\$ 9,173
Valuation allowance	(23)	(71)	(26)
Impaired loans, net of allowance	\$ 10,177	\$ 10,629	\$ 9,147
Average recorded investment in impaired loans <sup>(1)</sup>	\$ 12,017	\$ 14,147	\$ 11,585
Interest income recognized on impaired loans, after designation as impaired	\$ 192	\$ 149	\$ 553
Amount of income recognized on a cash basis	\$ ---	\$ ---	\$ ---

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

Nonaccrual loan relationships that meet the Company's balance threshold of \$250 and all TDRs are designated as impaired. The Company also designates as impaired other loan relationships that meet the Company's balance threshold of \$250 and for which the Company does not expect to collect according to the note's contractual terms. No interest income was recognized on nonaccrual loans for the six months ended June 30, 2017 or June 30, 2016 or for the year ended December 31, 2016.

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

<b>Impaired Loans as of June 30, 2017</b>						
	<b>Principal Balance</b>	<b>Total Recorded Investment<sup>(1)</sup></b>	<b>Recorded Investment<sup>(1)</sup> for Which There is No Related Allowance</b>	<b>Recorded Investment<sup>(1)</sup> for Which There is a Related Allowance</b>	<b>Related Allowance</b>	
<b>Real Estate Construction<sup>(2)</sup></b>						
Construction, other	\$ 3,300	\$ 3,300	\$ 3,300	\$ ---	\$ ---	
<b>Consumer Real Estate<sup>(2)</sup></b>						
Residential closed-end first liens	635	596	264	332	12	
Residential closed-end junior liens	184	184	---	184	6	
Investor-owned residential real estate	351	335	263	72	4	
<b>Commercial Real Estate<sup>(2)</sup></b>						
Commercial real estate, owner-occupied	2,996	2,991	2,699	292	1	
Commercial real estate, other	2,952	2,655	2,655	---	---	
<b>Commercial Non Real Estate<sup>(2)</sup></b>						
Commercial and industrial	153	137	137	---	---	
<b>Consumer Non Real Estate<sup>(2)</sup></b>						
Automobile	2	2	2	---	---	
<b>Total</b>	<b>\$ 10,573</b>	<b>\$ 10,200</b>	<b>\$ 9,320</b>	<b>\$ 880</b>	<b>\$ 23</b>	

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

<sup>(2)</sup> Only classes with impaired loans are shown.

**Impaired Loans as of December 31, 2016**

	<b>Principal Balance</b>	<b>Total Recorded Investment<sup>(1)</sup></b>	<b>Recorded Investment<sup>(1)</sup> for Which There is No Related Allowance</b>	<b>Recorded Investment<sup>(1)</sup> for Which There is a Related Allowance</b>	<b>Related Allowance</b>
<b>Real Estate Construction<sup>(2)</sup></b>					
Construction 1-4 family residential	\$ 280	\$ 270	\$ 270	\$ ---	\$ ---
<b>Consumer Real Estate<sup>(2)</sup></b>					
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
<b>Commercial Real Estate<sup>(2)</sup></b>					
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	---	---
<b>Commercial Non Real Estate<sup>(2)</sup></b>					
Commercial and industrial	255	241	241	---	---
<b>Consumer Non Real Estate<sup>(2)</sup></b>					
Automobile	3	3	3	---	---
<b>Total</b>	<b>\$ 9,820</b>	<b>\$ 9,173</b>	<b>\$ 8,269</b>	<b>\$ 904</b>	<b>\$ 26</b>

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

<sup>(2)</sup> Only classes with impaired loans are shown.

The following tables show the average recorded investment and interest income recognized for impaired loans.

	<b>For the Six Months Ended June 30, 2017</b>	
	<b>Average Recorded Investment<sup>(1)</sup></b>	<b>Interest Income Recognized</b>
<b>Real Estate Construction<sup>(2)</sup></b>		
Construction 1-4 family residential	\$ 3,335	\$ 89
<b>Consumer Real Estate<sup>(2)</sup></b>		
Residential closed-end first liens	603	18
Residential closed-end junior liens	190	6
Investor-owned residential real estate	335	2
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	887	---
Commercial real estate, owner occupied	3,777	77
Commercial real estate, other	2,681	---
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and industrial	207	---
<b>Consumer Non Real Estate<sup>(2)</sup></b>		
Automobile	2	---
<b>Total</b>	<b>\$ 12,017</b>	<b>\$ 192</b>

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

<sup>(2)</sup> Only classes with impaired loans are shown.

	For the Six Months Ended June 30, 2016	
	Average Recorded Investment <sup>(1)</sup>	Interest Income Recognized
<b>Real Estate Construction<sup>(2)</sup></b>		
Construction 1-4 family residential	\$ 678	\$ ---
<b>Consumer Real Estate<sup>(2)</sup></b>		
Residential closed-end first liens	664	20
Residential closed-end junior liens	213	7
Investor-owned residential real estate	75	2
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	1,595	---
Commercial real estate, owner occupied	4,807	120
Commercial real estate, other	5,203	---
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and Industrial	912	---
<b>Total</b>	<b>\$ 14,147</b>	<b>\$ 149</b>

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

<sup>(2)</sup> Only classes with impaired loans are shown.

	For the Year Ended December 31, 2016	
	Average Recorded Investment <sup>(1)</sup>	Interest Income Recognized
<b>Real Estate Construction<sup>(2)</sup></b>		
Construction 1-4 family residential	\$ 462	\$ 10
<b>Consumer Real Estate<sup>(2)</sup></b>		
Residential closed-end first liens	642	38
Residential closed-end junior liens	207	13
Investor-owned residential real estate	74	4
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	1,366	12
Commercial real estate, owner occupied	4,342	206
Commercial real estate, other	3,947	263
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and industrial	541	7
<b>Consumer Non Real Estate<sup>(2)</sup></b>		
Automobile	4	---
<b>Total</b>	<b>\$ 11,585</b>	<b>\$ 553</b>

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

<sup>(2)</sup> Only classes with impaired loans are shown.

The Company reviews nonaccrual loans on an individual loan basis to determine whether future payments are reasonably assured. To satisfy this criteria, 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. Nonaccrual loans that demonstrate reasonable assurance of future payments and that have made at least six consecutive payments in accordance with repayment terms and timeframes may be returned to accrual status.

A restructured loan that maintains current status for at least six months may be returned to accrual status.

An analysis of past due and nonaccrual loans follows.

**June 30, 2017**

	<b>30 – 89 Days Past Due and Accruing</b>	<b>90 or More Days Past Due</b>	<b>90 or More Days Past Due and Accruing</b>	<b>Nonaccruals<sup>(2)</sup></b>
<b>Consumer Real Estate<sup>(1)</sup></b>				
Equity lines	\$ 91	\$ ---	\$ ---	\$ ---
Residential closed-end first liens	901	---	---	---
Residential closed-end junior liens	185	---	---	---
Investor-owned residential real estate	165	8	---	271
<b>Commercial Real Estate<sup>(1)</sup></b>				
Multifamily real estate	57	---	---	---
Commercial real estate, owner-occupied	122	133	---	133
Commercial real estate, other	---	---	---	2,655
<b>Commercial Non Real Estate<sup>(1)</sup></b>				
Commercial and industrial	258	318	200	136
<b>Consumer Non Real Estate<sup>(1)</sup></b>				
Credit cards	2	5	5	---
Automobile	132	33	33	2
Other consumer loans	75	21	21	---
<b>Total</b>	<b>\$ 1,988</b>	<b>\$ 518</b>	<b>\$ 259</b>	<b>\$ 3,197</b>

<sup>(1)</sup> Only classes with past-due or nonaccrual loans are shown.

<sup>(2)</sup> Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

December 31, 2016

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

<sup>(1)</sup> Only classes with past-due or nonaccrual loans are shown.

<sup>(2)</sup> Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

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

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

Determination of risk grades was completed for the portfolio as of June 30, 2017 and December 31, 2016.

The following displays collectively-evaluated loans by credit quality indicator.

**June 30, 2017**

	Pass	Special Mention <sup>(1)</sup>	Classified <sup>(1)</sup>
<b>Real Estate Construction</b>			
Construction, 1-4 family residential	\$ 12,034	\$ ---	\$ ---
Construction, other	19,233	---	---
<b>Consumer Real Estate</b>			
Equity lines	16,941	49	58
Closed-end first liens	84,718	1,817	995
Closed-end junior liens	4,711	32	15
Investor-owned residential real estate	51,613	---	304
<b>Commercial Real Estate</b>			
Multifamily residential real estate	100,822	---	438
Commercial real estate owner-occupied	114,497	264	1,596
Commercial real estate, other	108,450	---	---
<b>Commercial Non Real Estate</b>			
Commercial and industrial	41,926	1,476	---
<b>Public Sector and IDA</b>			
States and political subdivisions	49,533	---	---
<b>Consumer Non Real Estate</b>			
Credit cards	5,684	---	---
Automobile	15,271	78	182
Other consumer	12,413	38	4
<b>Total</b>	<b>\$ 637,846</b>	<b>\$ 3,754</b>	<b>\$ 3,592</b>

<sup>(1)</sup> Excludes impaired, if any.

The following displays collectively-evaluated loans by credit quality indicator.

	Pass	Special Mention <sup>(1)</sup>	Classified <sup>(1)</sup>
<b>December 31, 2016</b>			
<b>Real Estate Construction</b>			
Construction, 1-4 family residential	\$ 11,635	\$ 3,468	\$ ---
Construction, other	20,972	---	---
<b>Consumer Real Estate</b>			
Equity lines	17,034	82	---
Closed-end first liens	83,658	1,267	580
Closed-end junior liens	4,861	15	151
Investor-owned residential real estate	48,277	333	583
<b>Commercial Real Estate</b>			
Multifamily residential real estate	99,002	1,733	---
Commercial real estate owner-occupied	120,170	1,188	1,425
Commercial real estate, other	103,534	1,543	80
<b>Commercial Non Real Estate</b>			
Commercial and industrial	35,521	3,229	33
<b>Public Sector and IDA</b>			
States and political subdivisions	45,474	---	---
<b>Consumer Non Real Estate</b>			
Credit cards	5,978	---	---
Automobile	14,457	25	192
Other consumer	12,229	636	8
<b>Total</b>	<b>\$ 622,802</b>	<b>\$ 13,519</b>	<b>\$ 3,052</b>

<sup>(1)</sup> Excludes impaired, if any.

#### Sales, Purchases and Reclassification of Loans

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

#### **Troubled Debt Restructurings**

From time to time the Company modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to \$6,899 at June 30, 2017, \$8,456 at December 31, 2016, and \$9,183 at June 30, 2016.

The following tables present restructurings by class that occurred during the three and six month periods ended June 30, 2017 and June 30, 2016. In both 2016 and 2017, the restructurings occurred in the second quarters; no restructurings occurred during the first quarters of either year.



<b>Restructurings That Occurred During the Three and Six Months Ended June 30, 2017</b>				
	<b>Number of Contracts</b>		<b>Pre-Modification Outstanding Principal Balance</b>	<b>Post-Modification Outstanding Principal Balance</b>
<b>Commercial Real Estate</b>				
Commercial real estate, other	<b>1</b>	<b>\$</b>	<b>132</b>	<b>\$ 132</b>
<b>Commercial Non Real Estate</b>				
Commercial and industrial	<b>2</b>		<b>118</b>	<b>118</b>
<b>Total</b>	<b>3</b>	<b>\$</b>	<b>250</b>	<b>\$ 250</b>

During the three month period ended June 30, 2017, the Company modified three loans in troubled debt restructurings. Each of the restructurings provided payment relief to the borrowers without forgiving principal or interest. One commercial non-real estate loan was restructured by extending the amortization period and lowering the payments. The other commercial non-real estate loan was restructured by decreasing the rate and changing the interest method from variable to fixed, as well as extending the amortization and reducing the payments. The commercial real estate loan's restructuring included a reduced interest rate and changing the interest method from variable to fixed. Interest was capitalized and the loan was re-amortized over a longer term. The loans were in nonaccrual prior to the restructuring and will remain in nonaccrual until they have met the Company's policy to return to accrual status. Impairment measurement did not result in a specific allocation for any of the loans restructured in 2017.

<b>Restructurings That Occurred During the Three and Six Months Ended June 30, 2016</b>				
	<b>Number of Contracts</b>		<b>Pre-Modification Outstanding Principal Balance</b>	<b>Post-Modification Outstanding Principal Balance</b>
<b>Commercial Real Estate</b>				
Commercial real estate, other	<b>2</b>		<b>3,008</b>	<b>3,008</b>
<b>Total</b>	<b>2</b>	<b>\$</b>	<b>3,008</b>	<b>\$ 3,008</b>

During the three month period ended June 30, 2016, the Company modified two loans in troubled debt restructurings. The loans were originally modified in troubled debt restructurings in 2014 to provide payment relief by lowering the interest rate and allowing interest-only payments. The restructurings completed in 2016 lowered the interest rate slightly from the 2014 restructured terms and returned the loans to amortization with payments of principal and interest. The loans were in nonaccrual prior to the 2016 restructuring and will remain in nonaccrual until they have met the Company's policy to return to accrual status. The loans are collateral dependent and the fair value is measured using the collateral method. Impairment measurement did not result in a specific allocation for either loan.

The Company analyzed its TDR portfolio for loans that defaulted during the three and six month periods ended June 30, 2017 and June 30, 2016, and that were modified within 12 months prior to default. The Company defines default as one or more payments that occur more than 90 days past the due date, charge-offs, or foreclosure after the date of restructuring. Of the restructured loans that defaulted during the three and six month periods ended June 30, 2017 and June 30, 2016, none were modified within 12 months prior to default.

#### Note 4: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type are as follows.

	June 30, 2017			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
<b>Available for Sale:</b>				
U.S. Government agencies and corporations	\$ 294,602	\$ 1,006	\$ 2,832	\$ 292,776
States and political subdivisions	8,283	159	---	8,442
Mortgage-backed securities	711	72	---	783
Corporate debt securities	6,015	255	28	6,242
Other securities	189	3	---	192
<b>Total securities available for sale</b>	<b>\$ 309,800</b>	<b>\$ 1,495</b>	<b>\$ 2,860</b>	<b>\$ 308,435</b>

	December 31, 2016			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
<b>Available for Sale:</b>				
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
<b>Total securities available for sale</b>	<b>\$ 309,802</b>	<b>\$ 808</b>	<b>\$ 6,328</b>	<b>\$ 304,282</b>

The amortized cost and fair value of single maturity securities available for sale at June 30, 2017, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

	June 30, 2017	
	Amortized Cost	Fair Value
<b>Available for Sale:</b>		
Due in one year or less	\$ 5,260	\$ 5,256
Due after one year through five years	209,331	207,524
Due after five years through ten years	69,853	69,207
Due after ten years	25,167	26,256
No maturity	189	192
<b>Total securities available for sale</b>	<b>\$ 309,800</b>	<b>\$ 308,435</b>

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type are as follows.

	June 30, 2017			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
<b>Held to Maturity:</b>				
U.S. Government agencies and corporations	\$ 3,934	\$ 243	\$ ---	\$ 4,177
States and political subdivisions	125,563	4,356	55	129,864
Mortgage-backed securities	236	26	---	262
Corporate debt securities	979	15	---	994
<b>Total securities held to maturity</b>	<b>\$ 130,712</b>	<b>\$ 4,640</b>	<b>\$ 55</b>	<b>\$ 135,297</b>

	December 31, 2016			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
<b>Held to Maturity:</b>				
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
<b>Total securities held to maturity</b>	<b>\$ 134,957</b>	<b>\$ 3,817</b>	<b>\$ 1,082</b>	<b>\$ 137,692</b>

The amortized cost and fair value of single maturity securities held to maturity at June 30, 2017, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

	June 30, 2017	
	Amortized Cost	Fair Value
<b>Held to maturity:</b>		
Due in one year or less	\$ 7,291	\$ 7,434
Due after one year through five years	28,071	29,623
Due after five years through ten years	22,723	23,633
Due after ten years	72,627	74,607
<b>Total securities held to maturity</b>	<b>\$ 130,712</b>	<b>\$ 135,297</b>

Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows.

	June 30, 2017			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Temporarily Impaired Securities:</b>				
U.S. Government agencies and corporations	\$ 241,874	\$ 2,781	\$ 7,949	\$ 51
States and political subdivisions	3,702	23	789	32
Corporate debt securities	949	28	---	---
<b>Total</b>	<b>\$ 246,525</b>	<b>\$ 2,832</b>	<b>\$ 8,738</b>	<b>\$ 83</b>

	December 31, 2016			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Temporarily Impaired Securities:</b>				
U.S. Government agencies and corporations	\$ 260,150	\$ 6,161	\$ 996	\$ 4
States and political subdivisions	31,257	934	1,316	148
Corporate debt securities	3,888	137	---	---
Other securities	---	---	163	26
<b>Total</b>	<b>\$ 295,295</b>	<b>\$ 7,232</b>	<b>\$ 2,475</b>	<b>\$ 178</b>

The Company had 261 securities with a fair value of \$255,263 that were temporarily impaired at June 30, 2017. The total unrealized loss on these securities was \$2,915. Of the temporarily impaired total, 9 securities with a fair value of \$8,738 and an unrealized loss of \$83 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at June 30, 2017 for the reasons set out below.

U.S. Government agencies. The unrealized losses of \$51 on US Government agency securities stemmed from 8 securities with a fair value of \$7,949. The unrealized loss was caused by interest rate and market fluctuations. The contractual term of the investments do not permit the issuers to settle the securities at a price less than the cost basis of the investments. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

States and political subdivisions. This category's unrealized loss of \$32 on 1 security with a fair value of \$789 is primarily the result of interest rate and market fluctuations. The contractual terms 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 purchases only investment-grade bonds with a Moody or Standard and Poor's rating of A or better, and that comply with regulatory requirements. Bond ratings are monitored on an ongoing basis. Municipal obligations that experience a decline in credit rating are analyzed to determine appropriate action and accounting treatment. The company performs an analysis each quarter to determine whether any investments are other-than-temporarily impaired. 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.

Restricted stock. The Company held restricted stock of \$1,200 as of June 30, 2017 and \$1,170 as of December 31, 2016. Restricted stock is reported separately from available-for-sale securities and held-to-maturity securities. As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required ownership amounts are determined by the correspondent banks based upon NBB's capital and 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 \$480,370 at June 30, 2017. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at June 30, 2017, management did not determine any impairment.

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

## Note 5: Recent Accounting Pronouncements

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 June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

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. 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.

During March 2017, the FASB issued ASU 2017-07, “Compensation — Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.” The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715 to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented in the income

statement separately from the service cost component. If the other components of net periodic benefit cost are not presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-07 to have a material impact on its consolidated financial statements.

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

During May 2017, the FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting.” The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for all entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The Company is currently assessing the impact that ASU 2017-08 will have on its consolidated financial statements.

## Note 6: Defined Benefit Plan

### Components of Net Periodic Benefit Cost

	<b>Pension Benefits</b>	
	<b>Six Months Ended June 30,</b>	
	<b>2017</b>	<b>2016</b>
Service cost	\$ 346	\$ 348
Interest cost	372	378
Expected return on plan assets	(548)	(544)
Amortization of prior service cost	(54)	(54)
Recognized net actuarial loss	270	286
Net periodic benefit cost	<u>\$ 386</u>	<u>\$ 414</u>

### 2017 Plan Year Employer Contribution

For the six months ended June 30, 2017, the Company contributed \$507 to the Plan.

## Note 7: Fair Value Measurements

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

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

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

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

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

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

#### Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

Description	Balance as of June 30, 2017	Fair Value Measurements at June 30, 2017 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agencies and corporations	\$ 292,776	\$ ---	\$ 292,776	\$ ---
States and political subdivisions	8,442	---	8,442	---
Mortgage-backed securities	783	---	783	---
Corporate debt securities	6,242	---	6,242	---
Other securities	192	---	192	---
Total securities available for sale	\$ 308,435	\$ ---	\$ 308,435	\$ ---

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

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

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

#### Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets offer at the report date for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at June 30, 2017 or December 31, 2016.

## Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due will not be collected when due according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan's balance exceeds fair value, the amount is allocated to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

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

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

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

Impaired loans are measured quarterly for impairment. The Company employs the most applicable valuation method for each loan based on current information at the time of valuation. Valuations of loans using the collateral method may include a discount for selling costs if collection of the loan is expected to come from sale of the collateral. Fair value measurement using the collateral method for a loan that is dependent on the operation, but not the sale, of collateral for collection is not discounted for selling costs.

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at June 30, 2017 and at December 31, 2016.

Date	Description	Balance	Carrying Value		
			Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:					
June 30, 2017	Impaired loans net of valuation allowance	\$ 857	\$ ---	\$ ---	\$ 857
December 31, 2016	Impaired loans net of valuation allowance	878	---	---	878

The following tables present information about Level 3 Fair Value Measurements for June 30, 2017 and December 31, 2016.

June 30, 2017	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	Present value of cash flows	Discount rate	6.75% – 8.00% (7.36%)

  

December 31, 2016	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	Present value of cash flows	Discount rate	6.75% – 8.00% (7.35%)



## Other Real Estate Owned

Other real estate owned are real estate assets acquired in full or partial satisfaction of a loan. At acquisition, other real estate owned assets are measured at fair value. If the assets are marketed for sale by an outside party, the acquisition-date fair value is discounted by selling costs; if the assets are marketed for sale by the Company, no reduction to fair value for selling costs is made. Subsequent to acquisition, the assets are measured at the lower of initial measurement or current fair value, discounted for selling costs as appropriate.

The fair value of an other real estate owned asset is determined by an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). If the appraisal is discounted either for age or because management considers the real estate market to be experiencing volatility, then the fair value is considered Level 3. Discounts for selling costs also result in measurement based on Level 3 inputs. Fair value adjustments are measured on a nonrecurring basis and are recorded in the period incurred as valuation allowances to other real estate owned, and expensed through noninterest expense.

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

Date	Description	Balance	Carrying Value		
			Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:					
June 30, 2017	Other real estate owned net of valuation allowance	\$ 3,008	\$	\$	\$ 3,008
December 31, 2016	Other real estate owned net of valuation allowance	3,156	---	---	3,156

The following tables present information about Level 3 Fair Value Measurements for June 30, 2017 and December 31, 2016.

June 30, 2017	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value	Selling cost	1.79% – 11.09% (4.91%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	1.41% – 53.46% (9.34%)
December 31, 2016	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value	Selling cost	2.91% – 8.60% (6.48%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0% – 53.46% (13.66%)

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

## Cash and Due from Banks and Interest-Bearing Deposits

The carrying amounts approximate fair value.

---

## Securities

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

## Loans Held for Sale

The fair value of loans held for sale is based on commitments on hand from investors or prevailing market prices.

## Loans

Fair value for the loan portfolio is estimated on an account-level basis by discounting scheduled cash flows through the projected maturity for each loan. The calculation applies estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified by an estimate of the effect of economic conditions on lending.

Impaired loans are individually evaluated for fair value. Fair value for the Company's impaired loans is estimated by using either discounted cash flows or the appraised value of collateral. Any amount of principal balance that exceeds fair value is accrued in the allowance for loan losses. Assumptions regarding credit risk, cash flows and discount rates are determined within management's judgment, using available market information and specific borrower information. Discount rates for cash flow analysis are based on the loan's interest rate, and cash flows are estimated based upon the loan's historical payment performance and the borrower's current financial condition. Appraisals may be discounted for age, reasonableness, and selling costs.

## Deposits

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

## Accrued Interest

The carrying amounts of accrued interest approximate fair value.

## Bank-Owned Life Insurance

Bank owned life insurance represents insurance policies on officers of the Company and certain officers who are no longer employed by the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

## Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are not deemed significant at June 30, 2017 and December 31, 2016, and, as such, the related fair values have not been estimated.

The estimated fair values and related carrying amounts of the Company's financial instruments follow.

<b>June 30, 2017</b>				
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>				
Cash and due from banks	\$ 12,936	\$ 12,936	\$ ---	\$ ---
Interest-bearing deposits	89,096	89,096	---	---
Securities	439,147	---	443,732	---
Restricted securities	1,200	---	1,200	---
Loans held for sale	491	---	491	---
Loans, net	646,362	---	---	647,133
Accrued interest receivable	5,139	---	5,139	---
Bank-owned life insurance	33,287	---	33,287	---
<b>Financial Liabilities:</b>				
Deposits	\$ 1,062,357	\$ ---	\$ 940,416	\$ 120,441
Accrued interest payable	43	---	43	---

<b>December 31, 2016</b>				
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>				
Cash and due from banks	\$ 13,974	\$ 13,974	\$ ---	\$ ---
Interest-bearing deposits	80,268	80,268	---	---
Securities	439,239	---	441,974	---
Restricted securities	1,170	---	1,170	---
Loans held for sale	478	---	478	---
Loans, net	639,452	---	---	658,386
Accrued interest receivable	5,260	---	5,260	---
Bank-owned life insurance	22,998	---	22,998	---
<b>Financial Liabilities:</b>				
Deposits	\$ 1,043,442	\$ ---	\$ 912,828	\$ 128,690
Accrued interest payable	55	---	55	---

**Note 8: Components of Accumulated Other Comprehensive Loss**

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
<b>Balance at December 31, 2015</b>	\$ (2,667)	\$ (5,270)	\$ (7,937)
Unrealized holding gain on available for sale securities, net of tax of \$2,170	4,032	---	4,032
Reclassification adjustment, net of tax of (\$18)	(34)	---	(34)
<b>Balance at June 30, 2016</b>	\$ 1,331	\$ (5,270)	\$ (3,939)
<b>Balance at December 31, 2016</b>	\$ (3,588)	\$ (5,071)	\$ (8,659)
Unrealized holding gain on available for sale securities net of tax of \$1,454	2,701	---	2,701
<b>Balance at June 30, 2017</b>	\$ (887)	\$ (5,071)	\$ (5,958)

The following provides information regarding reclassifications out of accumulated comprehensive loss for the three and six month periods ended June 30, 2017 and June 30, 2016.

	3 Months Ended		6 Months Ended	
	June 30, 2017	June 30, 2016	June 30, 2017	June 30, 2016
<b>Reclassifications out of unrealized gains and losses on available-for-sale securities:</b>				
Realized securities gain, net	\$ ---	\$ (46)	\$ ---	\$ (52)
Income taxes	---	(16)	---	(18)
Realized gain on available-for-sale securities, net of tax, reclassified out of accumulated other comprehensive loss	\$ ---	\$ (30)	\$ ---	\$ (34)

**Item 2. 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 financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the "Company"), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Please refer to the financial statements and other information included in this report as well as the 2016 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

**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 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 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 a separate nationally recognized firm to investigate and remediate the January 2017 intrusion. The firms provided the Company with recommendations concerning its systems and procedures. The Company adopted and implemented all of the recommendations resulting from the investigation of the May 2016 intrusion and is in the process of adopting and implementing the recommendations from the investigation of the January 2017 intrusion.

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 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 June 30, 2017, the Company has appropriately accounted for the breaches.

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.

### **Reclassifications**

During the second quarter of 2017, the Company re-classified the presentation of certain deposits from time deposits and interest-bearing deposits to savings deposits. Prior periods have been re-stated for comparability. Reclassifications had no effect on prior year net income or shareholders' equity.

### **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. The Company uses historical loss rates as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, 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, 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 or 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 that are made up of 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 of “substandard” or higher. 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 loan balances and not individually evaluated at the reporting date.

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 estimated loss for criticized loans within each class and for loans designated high risk. 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 June 30, 2017 considered market and portfolio conditions during the first six months of 2017 as well as the levels of delinquencies at June 30, 2017 and net charge-offs in the eight quarters prior to the quarter ended June 30, 2017. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

#### **Goodwill**

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company’s most recent impairment test was performed in the fourth quarter of 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.

#### **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. ("NBI") 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 ("NBB" or "the Bank") and National Bankshares Financial Services, Inc. ("NBFS"). NBB, which does business as National Bank from twenty-six full-service locations and one loan production office, is a community bank. NBB is the source of nearly all of the Company's revenue. 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.

NBI 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.

## **Lending**

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, small and mid-sized businesses, non-profits and local governments. 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. Of primary consideration in the Bank's decision to extend credit is the repayment ability of the borrowers and (if secured) the collateral value in relation to the principal balance. Collateral value lowers risk and may be used as a secondary source of repayment. The credit decision is 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 115% or greater, and is computed after deduction for a vacancy factor and property expenses, as appropriate. Borrower cash flow may be supplemented by a personal guarantee from the principal(s) of the 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.

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

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

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

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

## Performance Summary

The following table presents the Company's key performance ratios for the three months ended June 30, 2017 and June 30, 2016. The measures for June 30, 2017 and June 30, 2016 are annualized, except for basic earnings per share and fully diluted earnings per share.

	<b>Three Months Ended</b>	
	<b>June 30, 2017</b>	<b>June 30, 2016</b>
Return on average assets	<b>1.15 %</b>	1.28%
Return on average equity	<b>7.78 %</b>	8.66%
Basic earnings per share	<b>\$ 0.51</b>	\$ 0.56
Fully diluted earnings per share	<b>\$ 0.51</b>	\$ 0.56
Net interest margin <sup>(1)</sup>	<b>3.42 %</b>	3.52%
Noninterest margin <sup>(2)</sup>	<b>1.37 %</b>	1.23%

<sup>(1)</sup> Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

<sup>(2)</sup> 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 annualized return on average assets declined 13 basis points for the three months ended June 30, 2017 compared with the three months ended June 30, 2016. The annualized return on average equity decreased 88 basis points for the same period.

The annualized net interest margin was 3.42% for the three months ended June 30, 2017, down 10 basis points from the 3.52% reported for the three months ended June 30, 2016. The primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin worsened by 14 basis point from the three months ended June 30, 2016.

The following table presents the Company's key performance ratios for the six months ended June 30, 2017 and June 30, 2016 and the year ended December 31, 2016. The measures for June 30, 2017 and June 30, 2016 are annualized, except for the basic earnings per share and fully diluted earnings per share.

	<b>Six Months Ended</b>	<b>Six Months Ended</b>	<b>Twelve Months Ended</b>
	<b>June 30, 2017</b>	<b>June 30, 2016</b>	<b>December 31, 2016</b>
Return on average assets	<b>1.18 %</b>	1.28%	1.24 %
Return on average equity	<b>7.98 %</b>	8.65%	8.30 %
Basic earnings per share	<b>\$ 1.04</b>	\$ 1.10	\$ 2.15
Fully diluted earnings per share	<b>\$ 1.04</b>	\$ 1.10	\$ 2.15
Net interest margin <sup>(1)</sup>	<b>3.46 %</b>	3.59%	3.51 %
Noninterest margin <sup>(2)</sup>	<b>1.42 %</b>	1.35%	1.36 %

<sup>(1)</sup> Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

<sup>(2)</sup> 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 annualized return on average assets for the six months ended June 30, 2017 was 1.18%, a decline of 10 basis points compared with the six months ended June 30, 2016 and a decline of 6 basis points compared with the twelve months ended December 31, 2016.

The annualized return on average equity was 7.98% for the six months ended June 30, 2017, a decline from 8.65% for the six month period ended June 30, 2016 and 8.30% for the twelve month period ended December 31, 2016.

The annualized net interest margin was 3.46% for the six months ended June 30, 2017, down 13 basis points from the 3.59% reported for the six months ended June 30, 2016, and down 5 basis points from the 3.51% reported for the twelve months ended December 31, 2016. The primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin worsened by 7 basis points from the six months ended June 30, 2016 and worsened by 6 basis points from the twelve months ended December 31, 2016. Please refer to the discussions under noninterest income and noninterest expense for further information.

## Growth

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

	<b>June 30, 2017</b>	<b>December 31, 2016</b>	<b>Percent Change</b>
Interest-bearing deposits	\$ <b>89,096</b>	\$ 80,268	11.00 %
Securities, at carrying value	<b>440,347</b>	440,409	(0.01) %
Loans, net	<b>646,362</b>	639,452	1.08 %
Deposits	<b>1,062,357</b>	1,043,442	1.81 %
Total assets	<b>1,259,354</b>	1,233,942	2.06 %

## Asset Quality

Key indicators of the Company's asset quality are presented in the following table.

	<b>June 30, 2017</b>	<b>June 30, 2016</b>	<b>December 31, 2016</b>
Nonperforming loans	\$ <b>3,197</b>	\$ 6,205	\$ 5,855
Loans past due 90 days or more, and still accruing	<b>259</b>	316	63
Other real estate owned	<b>3,008</b>	3,425	3,156
Allowance for loan losses to loans	<b>1.28 %</b>	1.30%	1.28 %
Net charge-off ratio	<b>0.14 %</b>	0.31%	0.26 %
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	<b>0.94 %</b>	1.52%	1.38 %
Ratio of allowance for loan losses to nonperforming loans	<b>261.87 %</b>	132.07%	141.76 %

The Company's risk analysis at June 30, 2017 determined an allowance for loan losses of \$8,372 or 1.28% of loans, net of unearned income and deferred fees and costs. At December 31, 2016 the allowance for loan losses was \$8,300 or 1.28% of loans, net of unearned income and deferred fees and costs. At June 30, 2016 the allowance for loan losses was \$8,195 or 1.30% of loans, net of unearned income and deferred fees and costs. The determination of the appropriate level for the allowance for loan losses resulted in a provision for loan losses of \$523 for the six months ended June 30, 2017, compared with \$857 for the six months ended June 30, 2016 and \$1,650 for the twelve months ended December 31, 2016. To determine the appropriate level of the allowance for loan losses, the Company considers credit risk for certain loans designated as impaired and for non-impaired ("collectively evaluated") loans.

Individually evaluated impaired loans totaled \$10,200 with specific allocations to the allowance for loan losses of \$23 at June 30, 2017. Individually evaluated impaired loans at December 31, 2016 were \$9,173 with specific allocations to the allowance for loan losses of \$26. At June 30, 2016 individually evaluated impaired loans were \$10,700 with specific allocations totaling \$71. The specific allocation is determined based on criteria particular to each impaired loan.

Collectively evaluated loans totaled \$645,192 on a gross basis and \$644,535 net of unearned income and deferred fees and costs, with an allowance of \$8,349 or 1.30% of loans, net of unearned income and deferred fees and costs, at June 30, 2017. Collectively evaluated loans totaled \$639,373 on a gross basis and \$638,584 net of unearned income and deferred fees and costs, with an allowance of \$8,274 or 1.30% at December 31, 2016. At June 30, 2016, collectively evaluated loans totaled \$621,065 on a gross basis and \$620,224 net of unearned income and deferred fees and costs, with an allowance of \$8,124 or 1.31% of the collectively-evaluated portfolio.

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 qualitative factors that influence credit risk. Qualitative factors evaluated for impact to credit risk include economic measures, asset quality indicators, loan characteristics, and internal Company policies and management.

Net charge-offs for the six months ended June 30, 2017 were \$451 or 0.14% (annualized) of average loans, an improvement from \$959 or 0.31% (annualized) for the six months ended June 30, 2016 and from \$1,647 or 0.26% for the twelve months ended December 31, 2016. 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 June 30, 2017 are compared with data at December 31, 2016. Residential vacancy and the unemployment rate improved, resulting in a lower requirement for the allowance for loan losses. Lower residential vacancy rates are 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 and the inventory of new and existing

homes remained at similar levels to those at December 31, 2016, with the same allocation requirement. The Federal Reserve's increase to the federal funds rate is considered to slightly increase credit risk due to increased rates and payments for adjustable-rate loans, with a corresponding increase to the requirement for the allowance for loan losses. Additionally, the Company assessed negative impacts to credit risk for increases to the business and personal bankruptcy rates, resulting in an increased requirement for the allowance.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days decreased to 0.30% of total loans at June 30, 2017, from 0.39% at December 31, 2016 and 0.35% at June 30, 2016. Accruing loans past due 90 days or more as a percentage of total loans were 0.04% at June 30, 2017, compared with 0.01% at December 31, 2016 and 0.05% at June 30, 2016. Nonaccrual loans decreased to 0.49% of total loans at June 30, 2017, from 0.90% at December 31, 2016 and 0.98% at June 30, 2016. Decreases in past due and nonaccrual loans reduce the required level of the allowance for loan losses, while increases in past due and nonaccrual loans increase the required level of the allowance for loan losses.

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

Collectively evaluated loans rated "special mention" were \$3,754 at June 30, 2017, down from \$13,519 at December 31, 2016 and \$7,208 at June 30, 2016. Collectively evaluated loans rated classified were \$3,592 at June 30, 2017, slightly increased from \$3,052 at December 31, 2016, but decreased from \$4,850 at June 30, 2016.

Levels of high risk loans are considered in the determination of the level of the allowance for loan loss. High risk loans are defined by the Company as loans secured by junior liens, interest-only loans and loans with a high loan-to-value ratio. A decrease in the level of high risk loans within a class decreases the required allocation for the loan class, and an increase in the level of high risk loans within a class increases the required allocation for the loan class. Total high risk loans remained at a similar level to the level at December 31, 2016, with similar allocations at June 30, 2017 and December 31, 2016.

The calculation of the appropriate level for the allowance for loan losses incorporates analysis of multiple factors and requires management's prudent and informed judgment. The ratio of the allowance for loan losses to total loans, net of unearned income and deferred fees and costs at June 30, 2017 is 1.28%, the same level as the ratio at December 31, 2016. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.30%, the same level as the ratio at December 31, 2016. Improvements from December 31, 2016 in the charge-off rate, loans 30-89 days past due, nonaccrual loans and loans rated special mention decreased the required level of the allowance for loan losses, offset by worsening in personal and business bankruptcy rates, housing inventory, the interest rate environment, accruing loans past due 90 days or more and collectively evaluated classified loans. 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.

The following table discloses the other real estate owned in physical possession and in process at each reporting date:

Other Real Estate Owned <sup>(1)</sup>	June 30, 2017		June 30, 2016		December 31, 2016	
Real estate construction	\$	2,425	\$	2,683	\$	2,475
Consumer real estate		97		125		121
Commercial real estate		486		617		560
Total other real estate owned	\$	3,008	\$	3,425	\$	3,156
Other real estate owned in process	\$	133	\$	735	\$	321

<sup>(1)</sup> Net of valuation allowance.

Other real estate owned decreased \$148 from December 31, 2016 and \$417 from June 30, 2016. As of June 30, 2017, loans secured by real estate totaling \$133, all of which are secured by residential properties, are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB's other real estate owned properties are regularly marketed and sold.

The Company continues to monitor risk levels within the loan portfolio. Please refer to Note 3: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for further information on collectively-evaluated loans, individually-evaluated impaired loans and the unallocated portion of the allowance for loan losses.

## **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 dealing with the 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 are 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:

### **Six Months Ended June 30, 2017**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Total Amount Modified (in thousands)</b>
Rate reductions for competitive purposes	18	\$ 5,118
Payment extensions for less than 3 months	60	1,442
Maturity date extensions of more than 3 months and up to 6 months	113	16,954
Maturity date extensions of more than 6 months and up to 12 months	170	6,384
Advances on non-revolving loans or capitalization	4	3,364
Maturity date extensions of more than 12 months	9	1,132
Change in amortization term or method	15	3,070
Renewal of expired Home Equity Line of Credit loans for additional 10 years	6	213
Renewal of single-payment notes	123	2,459
Total modifications that do not constitute TDRs	518	\$ 40,136

### **Six Months Ended June 30, 2016**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Total Amount Modified (in thousands)</b>
Rate reductions for competitive purposes	25	\$ 16,680
Payment extensions for less than 3 months	56	1,406
Maturity date extensions of more than 3 months and up to 6 months	122	8,986
Maturity date extensions of more than 6 months and up to 12 months	137	6,709
Maturity date extensions of more than 12 months	6	2,503
Advances on non-revolving loans or capitalization	---	---
Change in amortization term or method	14	1,026
Renewal of expired Home Equity Line of Credit loans for additional 10 years	7	275
Renewal of single-payment notes	119	2,057
Total modifications that do not constitute TDRs	486	\$ 39,642

**Twelve Months Ended December 31, 2016**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Total Amount Modified (in thousands)</b>
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 capitalization	2	177
Change in amortization term or method	26	2,292
Renewal of expired Home Equity Line of Credit loans for additional 10 years	19	678
Renewal of single-payment notes	244	4,722
<b>Total modifications that do not constitute TDRs</b>	<b>1,016</b>	<b>\$ 81,555</b>

Modifications in which the borrower is experiencing financial difficulty and in 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.

The Company recognizes that the current economy, elevated 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 that do not demonstrate current payments for at least six months are maintained as 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's TDRs were \$6,899 at June 30, 2017, a decrease from \$8,456 at December 31, 2016. Accruing TDR loans amounted to \$3,711 at June 30, 2017 and \$3,769 at December 31, 2016. TDRs with at least six months of current payment history may accrue interest.

**TDR Status as of June 30, 2017**

	<b>Total TDR Loans</b>	<b>Accruing</b>			<b>Nonaccrual</b>
		<b>Current</b>	<b>30-89 Days Past Due</b>	<b>90+ Days Past Due</b>	
Consumer real estate	\$ 1,115	516	\$ 336	\$ ---	\$ 263
Commercial real estate	5,646	2,859	---	---	2,787
Commercial non real estate	136	---	---	---	136
Consumer non real estate	2	---	---	---	2
<b>Total TDR Loans</b>	<b>\$ 6,899</b>	<b>\$ 3,375</b>	<b>\$ 336</b>	<b>\$ ---</b>	<b>\$ 3,188</b>

TDR Status as of December 31, 2016					
	Total TDR Loans	Accruing			Nonaccrual
		Current	30-89 Days Past Due	90+ Days Past Due	
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
Consumer non real estate	3	---	---	---	3
<b>Total TDR Loans</b>	<b>\$ 8,456</b>	<b>\$ 3,609</b>	<b>\$ 160</b>	<b>\$ ---</b>	<b>\$ 4,687</b>

Restructuring generally results in a loan with either lower payments or a maturity extended beyond that originally required, and is expected to result in a lower risk of loss associated with nonperformance than the pre-modified loan. The Company modified three loans during the three and six month periods ended June 30, 2017 and modified 2 loans during the three and six month periods ended June 30, 2016. Please refer to Note 3 for information on troubled debt restructurings.

### Net Interest Income

The net interest income analysis for the three and six months ended June 30, 2017 and 2016 follows:

	Three Months Ended					
	June 30, 2017			June 30, 2016		
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
<b>Interest-earning assets:</b>						
Loans, net (1)(2)(3)(4)	\$ 652,208	\$ 7,617	4.68 %	\$ 610,413	\$ 7,444	4.90 %
Taxable securities (5)	309,598	1,397	1.81 %	283,699	1,567	2.22 %
Nontaxable securities (1)(5)(6)	131,913	1,877	5.71 %	140,107	1,991	5.72 %
Interest-bearing deposits	87,694	231	1.06 %	118,395	150	0.51 %
<b>Total interest-earning assets</b>	<b>\$ 1,181,413</b>	<b>\$ 11,122</b>	<b>3.78 %</b>	<b>\$ 1,152,614</b>	<b>\$ 11,152</b>	<b>3.89 %</b>
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 604,936	\$ 852	0.56 %	\$ 573,683	\$ 801	0.56 %
Savings deposits	141,291	61	0.17 %	135,273	81	0.24 %
Time deposits	120,838	135	0.45 %	142,566	181	0.51 %
<b>Total interest-bearing liabilities</b>	<b>\$ 867,065</b>	<b>\$ 1,048</b>	<b>0.48 %</b>	<b>\$ 851,522</b>	<b>\$ 1,063</b>	<b>0.50 %</b>
Net interest income and interest rate spread		<b>\$ 10,074</b>	<b>3.30 %</b>		<b>\$ 10,089</b>	<b>3.39 %</b>
Net yield on average interest-earning assets			<b>3.42 %</b>			<b>3.52 %</b>

- (1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three month periods presented.
- (2) Included in interest income are loan fees of \$70 and \$110 for the three months ended June 30, 2017 and 2016, respectively.
- (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.
- (6) Includes restricted stock.

	Six Months Ended					
	June 30, 2017			June 30, 2016		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
<b>Interest-earning assets:</b>						
Loans, net (1)(2)(3)(4)	\$ 651,064	\$ 15,233	4.72 %	\$ 610,471	\$ 14,949	4.92 %
Taxable securities (5)	309,983	2,799	1.82 %	268,689	3,244	2.43 %
Nontaxable securities (1)(5)(6)	133,176	3,787	5.73 %	141,487	4,023	5.72 %
Interest-bearing deposits	80,050	379	0.95 %	122,122	312	0.51 %
<b>Total interest-earning assets</b>	<b>\$ 1,174,273</b>	<b>\$ 22,198</b>	<b>3.81 %</b>	<b>\$ 1,142,769</b>	<b>\$ 22,528</b>	<b>3.96 %</b>
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 600,098	\$ 1,671	0.56 %	\$ 565,441	\$ 1,586	0.56 %
Savings deposits	138,921	125	0.18 %	133,883	170	0.26 %
Time deposits	124,994	280	0.45 %	145,908	375	0.52 %
<b>Total interest-bearing liabilities</b>	<b>\$ 864,013</b>	<b>\$ 2,076</b>	<b>0.48 %</b>	<b>\$ 845,232</b>	<b>\$ 2,131</b>	<b>0.51 %</b>
Net interest income and interest rate spread		\$ 20,122	3.33 %		\$ 20,397	3.45 %
Net yield on average interest-earning assets			<b>3.46 %</b>			<b>3.59 %</b>

- (1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the six month periods presented.
- (2) Included in interest income are loan fees of \$186 and \$213 for the six months ended June 30, 2017 and 2016, respectively.
- (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.
- (6) Includes restricted stock.

The following tables reconcile net interest income on a fully-taxable equivalent basis to net interest income on a GAAP basis.

	Three Months Ended June 30,	
	2017	2016
Net interest income, fully taxable equivalent basis	\$ 10,074	\$ 10,089
Less: taxable equivalent adjustment	(827)	(860)
<b>Net interest income</b>	<b>\$ 9,247</b>	<b>\$ 9,229</b>

	Six Months Ended June 30,	
	2017	2016
Net interest income, fully taxable equivalent basis	\$ 20,122	\$ 20,397
Less: taxable equivalent adjustment	(1,665)	(1,752)
<b>Net interest income</b>	<b>\$ 18,457</b>	<b>\$ 18,645</b>

The net interest margin decreased 10 basis points for the three month period ended June 30, 2017 and 13 basis points for the six month period ended June 30, 2017 when compared with the three and six month periods ended June 30, 2016. The decrease in interest rate spread was driven by a decline in the yield on earning assets of 11 basis points for the three month period and 15 basis points for the six month period, offset by a decline in the cost of interest-bearing liabilities of 2 basis points for the three month period and 3 basis points for the six month period when the periods ended June 30, 2017 and 2016 are compared.

The yield on loans declined 22 basis points and 20 basis points, respectively, when the three and six month periods ended June 30, 2017 are compared with the same periods ended June 30, 2016. The declines stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The yield on taxable securities declined 41 basis points when the three



month periods ended June 30, 2017 and June 30, 2016 are compared, and 61 basis points when the six months ended June 30, 2017 are compared with the same period in 2016. The yield on nontaxable securities decreased 1 basis point when the three month periods ended June 30, 2017 and June 30, 2016 are compared, but increased 1 basis point when the six month periods ended June 30, 2017 and June 30, 2016 are compared. The market yield for securities of a comparable term has generally declined over the past year, causing matured and called bonds to be replaced with lower yielding investments.

The decline in the cost of interest-bearing liabilities came from reductions in the cost of savings deposits and time deposits. The cost of savings deposits declined 7 basis points for the three month period and 8 basis points for the six month period ended June 30, 2017, when compared with the same periods ended June 30, 2016. The cost of time deposits declined 6 basis points and 7 basis points, respectively, when the three and six month periods ended June 30, 2017 and June 30, 2016 are compared. The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment.

### Provision and Allowance for Loan Losses

The provision for loan losses for the three and six month periods ended June 30, 2017 was \$464 and \$523 respectively, compared with \$654 and \$857 respectively, for the same periods ended June 30, 2016. The provision for loan losses is the result of a detailed analysis to estimate an adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at June 30, 2017 was 1.28%, which compares to 1.28% at December 31, 2016 and 1.30% at June 30, 2016. The net charge-off ratio was 0.14% for the six months ended June 30, 2017, 0.31% for the six months ended June 30, 2016 and 0.26% for the year ended December 31, 2016. See "Asset Quality" for additional information.

### Noninterest Income

	Three Months Ended		
	June 30, 2017	June 30, 2016	Percent Change
Service charges on deposits	\$ 692	\$ 569	21.62 %
Other service charges and fees	41	46	(10.87) %
Credit and debit card fees	1,019	969	5.16 %
Trust fees	361	354	1.98 %
BOLI income	146	151	(3.31) %
Other income	192	455	(57.80) %
Realized securities gain, net	4	74	(94.59) %

	Six Months Ended		
	June 30, 2017	June 30, 2016	Percent Change
Service charges on deposits	\$ 1,357	\$ 1,129	20.19 %
Other service charges and fees	110	118	(6.78) %
Credit and debit card fees	1,917	1,839	4.24 %
Trust fees	762	677	12.56 %
BOLI income	289	298	(3.02) %
Other income	520	800	(35.00) %
Realized securities gain, net	4	98	(95.92) %

Service charges on deposit accounts increased \$123 for the three month period and \$228 for the six month period ended June 30, 2017 when compared with the same periods ended June 30, 2016. The increase is primarily due to increased NSF and overdraft fee income from a new overdraft privilege program implemented in the third quarter of 2016.

Other service charges and fees decreased slightly when the three and six month periods ended June 30, 2017 are compared with the same periods ended June 30, 2016. Other service charges include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Service charges on deposits and other service charges and fees are subject to normal business fluctuation and are not due to changes in fee structure.

Credit and debit card fees for the three month period increased \$50 and increased \$78 for six month period ended June 30, 2017, when compared with the same periods last year. Credit and debit card fees are based on volume and other factors.

Income from trust fees increased \$7 or 1.98% for the three months ended June 30, 2017 and \$85 or 12.56% for the six months ended June 30, 2017, compared with the three and six month periods ended June 30, 2016. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income declined slightly for the three and six month periods ended June 30, 2017 when compared to the same periods in 2016. The Company purchased \$10 million in additional BOLI investments as of June 30, 2017, which will positively impact BOLI income in future quarters.

Other income includes fees on the sale of secondary-market mortgages, net gains from the sale of fixed assets, revenue from investment and insurance sales and other smaller miscellaneous components. These areas fluctuate with market conditions and because of competitive factors. Other income decreased \$263 or 57.80% for the three month period and \$280 or 35% for the six month period ended June 30, 2017, when compared with the same periods ended June 30, 2016. Most of the decrease was due to a one-time vendor signing incentives received in the second quarter of 2016.

The Company realized net securities gains of \$4 during the second quarter of 2017. The Company realized net securities gains of \$74 for the three month period and \$98 for the six month period ended June 30, 2016. Net realized securities gains and losses are market driven and have resulted from calls of securities.

### Noninterest Expense

	<b>Three Months Ended</b>		
	<b>June 30, 2017</b>	<b>June 30, 2016</b>	<b>Percent Change</b>
Salaries and employee benefits	\$ 3,438	\$ 2,907	18.27 %
Occupancy, furniture and fixtures	469	448	4.69 %
Data processing and ATM	541	595	(9.08)%
FDIC assessment	91	145	(37.24)%
Credit and debit card processing	725	712	1.83 %
Intangibles amortization	12	68	(82.35)%
Net costs of other real estate owned	55	39	41.03 %
Franchise taxes	329	322	2.17 %
Other operating expenses	1,038	1,002	3.59 %

	<b>Six Months Ended</b>		
	<b>June 30, 2017</b>	<b>June 30, 2016</b>	<b>Percent Change</b>
Salaries and employee benefits	\$ 6,981	\$ 6,475	7.81 %
Occupancy, furniture and fixtures	907	925	(1.95)%
Data processing and ATM	1,106	1,006	9.94 %
FDIC assessment	186	286	(34.97)%
Credit and debit card processing	1,380	1,334	3.45 %
Intangibles amortization	43	178	(75.84)%
Net costs of other real estate owned	84	108	(22.22)%
Franchise taxes	651	653	(0.31)%
Other operating expenses	2,297	1,957	17.37 %

Total noninterest expense increased \$460 or 7.37% for the three month period and \$713 or 5.52% for the six month period ended June 30, 2017 when compared with the same periods of 2016. The increases were driven by increases in salaries and employee benefits and other operating expenses, offset by decreases in the FDIC assessment and intangible asset amortization.

Salaries and employee benefits increased \$531 or 18.27% for the three month period and \$506 or 7.81% for the six month period ended June 30, 2017 when compared with the same periods in 2016. This expense category includes employee salaries, payroll taxes, insurance and fringe benefits, ESOP contribution accruals, defined benefit plan expense, and BOLI and salary continuation expenses. Insurance expense received a \$150 benefit in June 2016 for reduced funding requirements. BOLI and salary continuation plan expense increased \$43 while the remainder of the increase was due to normal staffing and compensation decisions.

Occupancy, furniture and fixtures expense increased slightly for the three month period and decreased \$18 for the six month period ended June 30, 2017, compared with the same periods of 2016.

Data processing and ATM expense decreased \$54 for the three month period and increased \$100 for the six month period ended June 30, 2017 when compared with the same periods of 2016. The increase for the six month period is due to investments in new technology and infrastructure.

FDIC assessment expense decreased \$54 for the three month period and \$100 for the six month period ended June 30, 2017 when compared with the same periods of 2016. The FDIC assessment is accrued based on a method provided by the FDIC. The calculation is based on average assets decreased by average tangible equity and incorporates risk-based factors to determine the amount of the assessment. 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.

Credit and debit card processing expense increased \$13 for the three month period and \$46 for the six month period ended June 30, 2017, compared with the same periods of 2016. This expense is driven by volume and other factors and is subject to a degree of variability.

Core deposit intangibles are the result of prior merger and acquisition activity and are amortized over a period of years. Some of the Company's intangible assets became fully amortized during the first half of 2016. This accounted for the decline in intangibles amortization expense of \$56 for the three month period and \$135 for the six month period ended June 30, 2017, compared with the same periods of 2016.

Net costs of other real estate owned increased \$16 for the three month period and decreased \$24 for the six month period ended June 30, 2017, compared with the same periods in 2016. The cost of other real estate owned includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market. OREO properties are accounted for at fair value less cost to sell upon foreclosure and are thereafter periodically appraised to determine market value. Declines in market value are recognized through valuation expense. During the first six months of 2017, the Company realized a net gain on the sale of OREO of \$4, compared with a net loss of \$40 on the sale of OREO during the first six months of 2016. Write downs on OREO properties were \$53 for the six months ended June 30, 2017, compared with \$15 for the six months ended June 30, 2016. Carrying expenses totaled \$35 for the six months ended June 30, 2017, compared with \$53 for the six months ended June 30, 2016.

Franchise tax expense for the three and six month periods ended June 30, 2017 was at similar levels to the same periods ended June 30, 2016. Franchise tax is based on capital levels of the subsidiary bank.

Other operating expense increased \$36 or 3.59% for the three month period and \$340 or 17.37% for the six month period ended June 30, 2017, compared with the same periods of 2016. The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations, losses and other expenses. The increase for the six-month period ended June 30, 2016 stemmed primarily from an increase of \$126 in consulting expense for investigation and remediation of the cybersecurity incidents, and an increase of \$101 paid to the vendor of the customer overdraft privilege program implemented in the third quarter of 2016 .

## **Balance Sheet**

Year-to-date daily averages for the major balance sheet categories are as follows:

<b>Assets</b>	<b>June 30, 2017</b>	<b>December 31, 2016</b>	<b>Percent Change</b>
Interest-bearing deposits	\$ 80,050	\$ 102,819	(22.14) %
Securities available for sale and restricted stock	306,019	279,892	9.33 %
Securities held to maturity	133,472	141,023	(5.35) %
Loans, net	642,561	613,366	4.76 %
<b>Total assets</b>	<b>1,233,594</b>	<b>1,206,745</b>	<b>2.22 %</b>
<b>Liabilities and stockholders' equity</b>			
Noninterest-bearing demand deposits	\$ 174,762	\$ 170,344	2.59 %
Interest-bearing demand deposits	600,098	568,916	5.48 %
Savings deposits	138,921	94,226	47.43 %
Time deposits	124,994	180,301	(30.67) %
<b>Stockholders' equity</b>	<b>182,319</b>	<b>171,732</b>	<b>1.26 %</b>

## Securities

Management regularly monitors the quality of the securities portfolio, and management closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 4: Securities for additional information.

## Loans

	<b>June 30, 2017</b>	<b>December 31, 2016</b>	<b>Percent Change</b>
Real estate construction loans	\$ 34,567	\$ 36,345	(4.89) %
Consumer real estate loans	162,368	157,718	2.95 %
Commercial real estate loans	331,713	336,457	(1.41) %
Commercial non real estate loans	43,539	39,024	11.57 %
Public sector and IDA	49,533	45,474	8.93 %
Consumer non real estate	33,672	33,528	0.43 %
Less: unearned income and deferred fees	(658)	(794)	(17.13) %
Loans, net of unearned income and deferred fees	\$ 654,734	\$ 647,752	1.08 %

The Company's loans, net of unearned income and deferred fees increased \$6,982 or 1.08% from \$647,752 at December 31, 2016 to \$654,734 at June 30, 2017. The increase stemmed primarily from an increase in commercial non real estate loans of \$4,515 or 11.57% and public sector and IDA loans of \$4,059 or 8.93%.

The Company does not now, nor has it ever, offered certain types of higher-risk loans such as subprime loans, option ARM products, reverse mortgages or loans with initial teaser rates.

## Deposits

	<b>June 30, 2017</b>	<b>December 31, 2016</b>	<b>Percent Change</b>
Noninterest-bearing demand deposits	\$ 181,868	\$ 171,946	5.77 %
Interest-bearing demand deposits	618,223	604,093	2.34 %
Saving deposits	140,325	136,789	2.59 %
Time deposits	121,941	130,614	(6.64) %
Total deposits	\$ 1,062,357	\$ 1,043,442	1.81 %

Total deposits increased \$18,915 or 1.81% from \$1,043,442 at December 31, 2016 to \$1,062,357 at June 30, 2017. Increases in noninterest-bearing demand deposits, interest-bearing demand deposits and savings deposits totaled \$27,588 when June 30, 2017 is compared with December 31, 2016. These increases were offset by a decline in time deposits of \$8,673 when June 30, 2017 is compared with December 31, 2016. Historically low rates have caused a migration from time deposits to other types of deposits. As longer-term certificates of deposit mature, customers appear unwilling to commit their funds for extended periods at low interest rates. Time deposits do not include any brokered deposits.

## 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 sources of liquidity, 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 ("FHLB") advances. At June 30, 2017, the bank did not have purchased deposits, 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 or decreased liquidity from public funds deposits or discount window borrowings

results in increased or decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and the amount of unpledged available-for-sale securities that are accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to utilize purchased deposits and the Federal Reserve discount window for liquidity needs. At June 30, 2017, the Company is considered well capitalized and does not have any restrictions on purchased deposits or 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 June 30, 2017, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities. It also tests 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 June 30, 2017, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At June 30, 2017, the loan to deposit ratio was 61.75%, slightly below the Company's internal target. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered to account for projected funding needs.

### **Capital Resources**

Total stockholders' equity at June 30, 2017 was \$184,286, an increase of \$6,023 or 3.38%, from the \$178,263 at December 31, 2016.

Risk based capital ratios are shown in the following table.

	<b>Ratios at June 30, 2017</b>	<b>Regulatory Capital Minimum Ratios</b>	<b>Regulatory Capital Minimum Ratios with Capital Conservative Buffer</b>
Common Equity Tier I Capital Ratio	<b>24.09 %</b>	4.50 %	5.75 %
Tier I Capital Ratio	<b>24.09 %</b>	6.00 %	7.25 %
Total Capital Ratio	<b>25.17 %</b>	8.00 %	9.25 %
Leverage Ratio	<b>15.07 %</b>	4.00 %	4.00 %

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 June 30, 2017.

Beginning January 1, 2016, a capital conservation buffer of .625% became effective. The capital conservation buffer for 2017 is 1.25%. 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**

In the normal course of business, NBB extends lines of credit and letters of credit to its customers. Depending on their needs, customers may draw upon lines of credit at any time in any amount up to a pre-approved limit. Standby letters of credit are issued for two purposes. Financial letters of credit guarantee payments to facilitate customer purchases. Performance letters of credit guarantee payment if the customer fails to complete a specific obligation.

Historically, the full approved amount of letters and lines of credit has not been drawn at any one time. The Company has developed plans to meet a sudden and substantial funding demand. These plans include accessing a line of credit with a correspondent bank, borrowing from the FHLB, selling available for sale investments or loans and raising additional deposits.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. Mortgages must meet strict underwriting and documentation requirements for the sale to be completed. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of June 30, 2017. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the six months ended June 30, 2017, except for normal seasonal fluctuations in the total of mortgage loan commitments.

---

## **Contractual Obligations**

The Company had no capital lease or purchase obligations and no long-term debt at June 30, 2017. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material as of June 30, 2017 and have not changed materially from those which were disclosed in the Company's 2016 Form 10-K.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2016 in the Company's 2016 Form 10-K.

### **Item 4. Controls and Procedures**

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of June 30, 2017 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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

## **Part II**

### **Other Information**

#### **Item 1. Legal Proceedings**

There are no pending or threatened legal proceedings to which the Company or any of its subsidiaries is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

#### **Item 1A. Risk Factors**

Please refer to the "Risk Factors" previously disclosed in Item 1A of our 2016 Annual Report on Form 10-K and the factors discussed under "Cautionary Statement Regarding Forward-Looking Statements" in Part I. Item 2 of this Form 10-Q.

#### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

#### **Item 3. Defaults Upon Senior Securities**

None.

#### **Item 4. Mine Safety Disclosures**

Not applicable.

---

**Item 5. Other Information**

None.

**Item 6. Exhibits**

See Index of Exhibits.

**Signatures**

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

NATIONAL BANKSHARES, INC.

Date: August 9, 2017

/s/ James G. Rakes

James G. Rakes  
Chairman, President and  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 9, 2017

/s/ David K. Skeens

David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)

## Index of Exhibits

<b>Exhibit No.</b>	<b>Description</b>	<b>Page No. in Sequential System</b>
3(i)	Amended and Restated Articles of Incorporation of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	Amended By-laws of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3(ii) of the Form 8K filed on July 9, 2014)
4	Specimen copy of certificate for National Bankshares, Inc. common stock	(incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)
*10(i)	National Bankshares, Inc. 1999 Stock Option Plan	(incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999)
*10(ii)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015)
*10(iii)	Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg	(incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002)
*10(iv)	Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015)
*10(v)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vi)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vii)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(viii)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)
*10(ix)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)
*10(x)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xi)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on June 12, 2008)
*10(xii)	Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)
*10(xiii)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xiv)	Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)



*10(xv)	Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xvii)	Second Salary Continuation Agreement dated July 1, 2016 between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on July 20, 2016)
*10(xviii)	Salary Continuation Agreement dated February 6, 2006 between The National Bankshares, Inc. and Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xix)	First Amendment, dated December 19, 2007, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xx)	Second Amendment, dated June 12, 2008, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xxi)	Third Amendment, dated June 22, 2016, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
+23	Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8	(incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2016)
+31(i)	Section 906 Certification of Chief Executive Officer	(included herewith)
+31(ii)	Section 906 Certification of Chief Financial Officer	(included herewith)
+32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	(included herewith)
+32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	(included herewith)
+101	The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended June 30, 2017 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Statements of Income for the three and six month periods ended June 30, 2017 and 2016; (ii) Consolidated Statements of Comprehensive Income for the three and six month periods ended June 30, 2017 and 2016; (iii) Consolidated Balance Sheets at June 30, 2017 and December 31, 2016; (iv) Consolidated Statements of Changes in Stockholders' Equity for the six months ended June 30, 2017 and 2016; (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016; and (vi) Notes to Consolidated Financial Statements.	(included herewith)

\* Indicates a management contract or compensatory plan.

CERTIFICATIONS

I, James G. Rakes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2017

/s/ James G. Rakes

James G. Rakes  
Chairman, President and Chief Executive Officer  
(Principal Executive Officer)

CERTIFICATIONS

I, David K. Skeens, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2017

/s/ David K. Skeens  
David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)

---

Exhibit 32 (i)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended June 30, 2017, I, James G. Rakes, Chairman, President and Chief Executive Officer (Principal Executive Officer) of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended June 30, 2017, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended June 30, 2017, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ James G. Rakes

James G. Rakes  
Chairman, President and Chief Executive Officer  
(Principal Executive Officer)  
August 9, 2017

Exhibit 32 (ii)

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended June 30, 2017, I, David K. Skeens, Treasurer and Chief Financial Officer (Principal Financial Officer) of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended June 30, 2017, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended June 30, 2017, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ David K. Skeens

David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)  
August 9, 2017