

NATIONAL BANKSHARES INC
Form 10-Q
November 07, 2018

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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 September 30, 2018

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

For the transition period from _____ to _____

Commission File Number 0-15204

NATIONAL BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

Virginia

54-1375874

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

101 Hubbard Street

P. O. Box 90002

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Blacksburg, VA 24062-9002
(Address of principal executive offices) (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

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

<u>Class</u>	<u>Outstanding at November 6, 2018</u>
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Common Stock, \$1.25 Par Value (This report contains 64 pages)	6,957,974
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National Bankshares, Inc. and Subsidiaries

Consolidated Balance Sheets

	(Unaudited)	
	September 30, 2018	December 31, 2017
(in thousands, except share and per share data)		
Assets		
Cash and due from banks	\$ 11,533	\$ 12,926
Interest-bearing deposits	28,328	51,233
Securities available for sale, at fair value	448,485	331,387
Securities held to maturity (fair value of \$130,113 at December 31, 2017)	---	127,164
Restricted stock, at cost	2,708	1,200
Loans held for sale	1,027	260
Loans:		
Loans, net of unearned income and deferred fees and costs	701,834	668,069
Less allowance for loan losses	(7,713)	(7,925)
Loans, net	694,121	660,144
Premises and equipment, net	8,727	8,221
Accrued interest receivable	5,589	5,297
Other real estate owned, net	2,214	2,817
Intangible assets and goodwill	5,861	5,898
Bank-owned life insurance	34,434	33,756
Other assets	15,262	16,454
Total assets	\$ 1,258,289	\$ 1,256,757
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	\$ 199,953	\$ 182,511
Interest-bearing demand deposits	584,305	622,189
Savings deposits	141,751	140,150
Time deposits	96,167	114,884
Total deposits	1,022,176	1,059,734
Other borrowed funds	35,000	---
Accrued interest payable	165	62
Other liabilities	12,791	12,065
Total liabilities	1,070,132	1,071,861
Commitments and contingencies		
Stockholders' Equity		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	---	---
Common stock of \$1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,957,974 shares at September 30, 2018 and at December 31, 2017	8,698	8,698

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Retained earnings	193,445	185,893
Accumulated other comprehensive loss, net	(13,986)	(9,695)
Total stockholders' equity	188,157	184,896
Total liabilities and stockholders' equity	\$ 1,258,289	\$ 1,256,757

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Three Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands, except share and per share data)	September 30, 2018	September 30, 2017
Interest Income		
Interest and fees on loans	\$ 8,005	\$ 7,473
Interest on interest-bearing deposits	111	224
Interest on securities – taxable	1,771	1,426
Interest on securities – nontaxable	1,058	1,178
Total interest income	10,945	10,301
Interest Expense		
Interest on time deposits	107	130
Interest on other deposits	1,034	891
Interest on borrowed funds	104	---
Total interest expense	1,245	1,021
Net interest income	9,700	9,280
Provision for loan losses	223	201
Net interest income after provision for loan losses	9,477	9,079
Noninterest Income		
Service charges on deposit accounts	673	710
Other service charges and fees	20	42
Credit and debit card fees	362	315
Trust income	355	365
BOLI income	222	233
Other income	282	215
Realized securities gain, net	---	4
Total noninterest income	1,914	1,884
Noninterest Expense		
Salaries and employee benefits	3,639	3,478
Occupancy and furniture and fixtures	433	459
Data processing and ATM	684	565
FDIC assessment	88	93
Intangible assets amortization	12	13
Net costs of other real estate owned	274	58
Franchise taxes	314	332

Other operating expenses	1,019	1,033
Total noninterest expense	6,463	6,031
Income before income taxes	4,928	4,932
Income tax expense	677	1,147

(continued)

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Net Income	\$4,251	\$3,785
Basic net income per common share	\$0.61	\$0.54
Fully diluted net income per common share	\$0.61	\$0.54
Weighted average number of common shares outstanding – basic and diluted	6,957,974	6,957,974
Dividends declared per common share	---	---

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Three Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	September 30, 2018	September 30, 2017
Net Income	\$ 4,251	\$ 3,785
Other Comprehensive Loss, Net of Tax		
Unrealized holding loss on available for sale securities net of tax of (\$517) and (\$219) for the periods ended September 30, 2018 and 2017, respectively	(1,945)	(407)
Reclassification adjustment for gain included in net income, net of tax of (\$1) for the period ended September 30, 2017	---	(3)
Other comprehensive loss, net of tax	(1,945)	(410)
Total Comprehensive Income	\$ 2,306	\$ 3,375

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands, except share and per share data)	September 30, 2018	September 30, 2017
Interest Income		
Interest and fees on loans	\$ 23,159	\$ 22,379
Interest on interest-bearing deposits	509	603
Interest on securities – taxable	5,125	4,225
Interest on securities – nontaxable	3,362	3,627
Total interest income	32,155	30,834
Interest Expense		
Interest on time deposits	344	410
Interest on other deposits	3,023	2,687
Interest on borrowed funds	104	---
Total interest expense	3,471	3,097
Net interest income	28,684	27,737
Provision for loan losses	93	724
Net interest income after provision for loan losses	28,591	27,013
Noninterest Income		
Service charges on deposit accounts	2,037	2,067
Other service charges and fees	87	152
Credit and debit card fees	1,071	854
Trust income	1,131	1,127
BOLI income	678	522
Other income	801	735
Realized securities gain, net	---	8
Total noninterest income	5,805	5,465
Noninterest Expense		
Salaries and employee benefits	10,878	10,420
Occupancy and furniture and fixtures	1,396	1,366
Data processing and ATM	2,024	1,673
FDIC assessment	269	279
Intangible assets amortization	37	56
Net costs of other real estate owned	523	142
Franchise taxes	965	983

Write-down of insurance receivable	2,010	---
Other operating expenses	2,949	3,369
Total noninterest expense	21,051	18,288
Income before income taxes	13,345	14,190
Income tax expense	1,757	3,186
<i>(continued)</i>		

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Net Income	\$11,588	\$11,004
Basic net income per common share	\$1.67	\$1.58
Fully diluted net income per common share	\$1.67	\$1.58
Weighted average number of common shares outstanding – basic and diluted	6,957,974	6,957,974
Dividends declared per common share	\$0.58	\$0.56

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	September 30, 2018	September 30, 2017
Net Income	\$ 11,588	\$ 11,004
Other Comprehensive Income (Loss), Net of Tax		
Unrealized holding gain (loss) on available for sale securities net of tax of (\$1,378) and \$1,235 for the periods ended September 30, 2018 and 2017, respectively	(5,182)	2,294
Unrealized holding gain on securities transferred from held to maturity to available for sale, net of tax of \$237 for the period ended September 30, 2018	891	---
Reclassification adjustment for gain included in net income, net of tax of (\$1) for the period ended September 30, 2017.	---	(3)
Other comprehensive income (loss), net of tax	(4,291)	2,291
Total Comprehensive Income	\$ 7,297	\$ 13,295

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

(Unaudited)

Three Months Ended September 30, 2018 and 2017

(in thousands)	Accumulated			Total
	Common Stock	Retained Earnings	Other Comprehensive Loss	
Balances at June 30, 2017	\$ 8,698	\$ 181,546	\$ (5,958	) \$ 184,286
Net income	---	3,785	---	3,785
Other comprehensive loss, net of tax of (\$220)	---	---	(410	) (410)
Balances at September 30, 2017	\$ 8,698	185,331	(6,368	) 187,661
Balances at June 30, 2018	\$ 8,698	\$ 189,194	\$ (12,041	) \$ 184,851
Net income	---	4,251	---	4,251
Other comprehensive loss, net of tax of (\$517)	---	---	(1,945	) (1,945)
Balances at September 30, 2018	\$ 8,698	\$ 193,445	\$ (13,986	) \$ 188,157

See accompanying notes to consolidated financial statements.

Nine Months Ended September 30, 2018 and 2017

(in thousands)	Accumulated			Total
	Common Stock	Retained Earnings	Other Comprehensive Loss	
Balances at December 31, 2016	\$ 8,698	\$ 178,224	\$ (8,659	) \$ 178,263
Net income	---	11,004	---	11,004
Dividends \$0.56 per share	---	(3,897) ---	(3,897)
Other comprehensive income, net of tax of \$1,234	---	---	2,291	2,291

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Balances at September 30, 2017	\$ 8,698	185,331	(6,368)	187,661
Balances at December 31, 2017	\$ 8,698	\$185,893	\$ (9,695)	\$184,896
Net income	---	11,588	---		11,588
Dividends \$0.58 per share	---	(4,036	)	---	(4,036
Other comprehensive loss, net of tax of (\$1,141)	---	---	(4,291	)	(4,291
Balances at September 30, 2018	\$ 8,698	\$193,445	\$ (13,986)	\$188,157

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	September 30, 2018	September 30, 2017
Cash Flows from Operating Activities		
Net income	\$ 11,588	\$ 11,004
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	93	724
Depreciation of bank premises and equipment	595	601
Amortization of intangibles	37	56
Amortization of premiums and accretion of discounts, net	43	44
Gain on sales and calls of securities available for sale, net	---	(4)
Gain on calls of securities held to maturity, net	---	(4)
Loss and write-down on other real estate owned, net	464	79
Increase in cash value of bank-owned life insurance	(678)	(522)
Origination of mortgage loans held for sale	(11,032)	(9,666)
Proceeds from sale of mortgage loans held for sale	10,430	9,777
Gain on sale of mortgage loans held for sale	(165)	(138)
Write-down of insurance receivable	2,010	---
Net change in:		
Accrued interest receivable	(292)	137
Other assets	323	(1,661)
Accrued interest payable	103	(4)
Other liabilities	726	616
Net cash provided by operating activities	14,245	11,039
Cash Flows from Investing Activities		
Net change in interest-bearing deposits	22,905	22,008
Proceeds from calls, principal payments, sales and maturities of securities available for sale	22,424	10,589
Proceeds from calls, principal payments and maturities of securities held to maturity	6,430	6,466
Purchase of securities available for sale	(24,263)	(12,081)
Purchases of securities held to maturity	---	(1,319)
Net change in restricted stock	(1,508)	(30)
Purchase of BOLI	---	(10,000)
Purchase of loan participations	(7,726)	(1,296)
Collection of loan participations	856	751
Loan originations and principal collections, net	(27,382)	(12,851)
Proceeds from sale of other real estate owned	139	251

Recoveries on loans charged off	182	138
Proceeds from sale and purchases of premises and equipment, net	(1,101	) (207
Net cash used in investing activities	(9,044	) 2,419

(continued)

Table of Contents**Cash Flows from Financing Activities**

Net change in time deposits	(18,717)	(11,895)
Net change in other deposits	(18,841)	426
Cash dividends paid	(4,036)	(3,897)
Borrowing advances	35,000	---
Net cash used in financing activities	(6,594)	(15,366)
Net change in cash and due from banks	(1,393)	(1,908)
Cash and due from banks at beginning of period	12,926	13,974
Cash and due from banks at end of period	\$11,533	\$12,066

Supplemental Disclosures of Cash Flow Information

Interest paid on deposits and borrowed funds	\$3,368	\$3,101
Income taxes paid	1,054	2,872

Supplemental Disclosure of Noncash Activities

Loans charged against the allowance for loan losses	\$487	\$689
Loans transferred to other real estate owned	---	97
Unrealized net gain (loss) on securities available for sale	(6,560)	3,525
Unrealized net gain on securities transferred from held to maturity to available for sale	1,128	---
Fair value of securities transferred from held to maturity to available for sale	119,790	---

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

September 30, 2018

(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 nine month period ended September 30, 2018 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 2017 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.

Accounting Standards Adopted in 2018

ASU No. 2014-09, “Revenue from Contracts with Customers”

In May 2014, the FASB issued ASU No. 2014-09, “*Revenue from Contracts with Customers*.” The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies generally will be required to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Subsequent to the issuance of ASU 2014-09, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2016-08, “*Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*,” ASU No. 2016-10, “*Identifying Performance Obligations and Licensing*,” ASU No.

2016-12, “*Narrow-Scope Improvements and Practical Expedients*,” and ASU No. 2016-20 “*Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*.” For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, merchant income, bank-financed sales of other real estate owned and annuity and insurance commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross vs. net). Based on its evaluation, the Company determined that the classification of certain debit and credit card related costs should change (i.e., cost previously recorded as expense is now recorded as contra-revenue). The Company identified \$2,093 previously presented as credit card processing expense for the nine months ended September 30, 2017 and \$715 for the three months ended September 30, 2017, and reclassified it to net against credit card fee income. The Company adopted ASU 2014-09 and its related amendments on its required effective date of January 1, 2018 utilizing the full retrospective approach. There was no impact to net income. Consistent with the full retrospective approach, the Company adjusted prior period amounts for the debit and credit card costs reclassifications noted above.

Table of Contents*ASU No. 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities”*

In January 2016, the FASB issued ASU No. 2016-01, “*Recognition and Measurement of Financial Assets and Financial Liabilities.*” This ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP. The provisions of the ASU that apply to the Company are as follows: (1) require 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. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement 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 on the balance sheet; (4) require use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (6) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets. The adoption of ASU No. 2016-01 on January 1, 2018 did not have a material impact on the Company’s Consolidated Financial Statements. In accordance with (4) above, the Company measured the fair value of its loan portfolio and time deposit portfolio as of September 30, 2018 using an exit price notion (see Note 14 *Fair Value of Assets and Liabilities*).

ASU No. 2017-07, “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost”

In March 2017, the FASB issued ASU No. 2017-07, “*Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.*” Under the new guidance, employers are required to present the service cost component of the net periodic benefit cost in the same income statement line item (e.g., Salaries and Employee Benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components of net periodic benefit cost separately (e.g., Other Noninterest Expense) from the line item that includes the service cost. ASU No. 2017-07 is effective for interim and annual reporting periods beginning after December 15, 2017. Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component will be applied prospectively. The Company adopted ASU No. 2017-07 on January 1, 2018 and utilized the ASU’s practical expedient allowing entities to estimate amounts for comparative periods using the information previously disclosed in their pension and other postretirement benefit plan footnote and re-classified non-servicing components of net periodic pension cost from compensation expense to other noninterest expense. ASU No. 2017-07 did not have a material impact on the Company’s Consolidated Financial Statements.

Note 2: Loan Portfolio

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

	September 30,	December 31,
	2018	2017
Real estate construction	\$ 42,548	\$ 34,694
Consumer real estate	171,679	166,965
Commercial real estate	346,756	340,414
Commercial non real estate	44,497	40,518
Public sector and IDA	59,369	51,443
Consumer non real estate	37,587	34,648
Gross loans	702,436	668,682
Less unearned income and deferred fees and costs	(602)	(613)
Loans, net of unearned income and deferred fees and costs	\$ 701,834	\$ 668,069

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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

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

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Restructured loans are individually evaluated for impairment, and the amount of a restructured loan's book value in excess of its fair value is accrued as a specific allocation in the allowance for loan losses. If a TDR loan payment exceeds 90 days past due, it is examined to determine whether the late payment indicates collateral dependency or cash flows below those that were used in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent are charged down to fair value. Deficiencies indicated by impairment measurements for TDRs that are not collateral dependent may be accrued in the allowance for loan losses or charged off if deemed uncollectible.

Collectively-Evaluated Loans

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

Portfolio Segments and Classes

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

Real Estate Construction

Construction, residential

Construction, other

Commercial Non Real Estate

Commercial and industrial

Consumer Real Estate

Equity lines

Public Sector and IDA

Residential closed-end first liens

Public sector and IDA

Residential closed-end junior liens

Investor-owned residential real estate

Consumer Non Real Estate

Credit cards

Commercial Real Estate

Automobile

Multifamily real estate

Other consumer loans

Commercial real estate, owner-occupied

Commercial real estate, other

Historical Loss Rates

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

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

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Risk Factors

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

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans, and the percentage of high risk loans within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Please refer to Note 1: Summary of Significant Accounting Policies of Form 10-K for a discussion of risk factors pertinent to each class.

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

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

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

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

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

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

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

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

**Activity in the Allowance for Loan Losses for the Nine Months Ended
September 30, 2018**

	Real Estate Construction	Consumer Estate	Commercial Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2017	\$337	\$ 2,027	\$ 3,044	\$ 1,072	\$ 419	\$ 707	\$ 319	\$7,925
Charge-offs	---	(36)	---	(107)	---	(344)	---	(487)
Recoveries	---	2	37	22	---	121	---	182
Provision for (recovery of) loan losses	137	185	(42)	(305)	151	240	(273)	93
Balance, September 30, 2018	\$474	\$ 2,178	\$ 3,039	\$ 682	\$ 570	\$ 724	\$ 46	\$7,713

Table of Contents**Activity in the Allowance for Loan Losses for the Nine Months Ended September 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	---	(146)	(122)	(73)	---	(348)	---	(689)
Recoveries	---	1	44	14	---	79	---	138
Provision for (recovery of) loan losses	(140)	337	33	111	55	357	(29)	724
Balance, September 30, 2017	\$298	\$ 2,022	\$ 3,693	\$ 1,115	\$ 385	\$ 732	\$ 228	\$8,473

Activity in the Allowance for Loan Losses for the Year Ended December 31, 2017

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

Allowance for Loan Losses as of September 30, 2018

	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	\$---	\$ 14	\$ ---	\$ 142	\$ ---	\$ ---	\$ ---	\$156
Collectively evaluated for impairment	474	2,164	3,039	540	570	724	46	7,557
Total	\$474	\$ 2,178	\$ 3,039	\$ 682	\$ 570	\$ 724	\$ 46	\$7,713

Allowance for Loan Losses as of December 31, 2017

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

Table of Contents**Loans as of September 30, 2018**

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	\$2,470	\$1,688	\$6,610	\$1,149	\$---	\$17	\$---	\$11,934
Collectively evaluated for impairment	40,078	169,991	340,146	43,348	59,369	37,570	---	690,502
Total	\$42,548	\$171,679	\$346,756	\$44,497	\$59,369	\$37,587	\$---	\$702,436

Loans as of December 31, 2017

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

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

	As of and for the			
	Nine Months Ended		Year Ended	
	September, 2018	2017	December 31, 2017	
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs	1.10 %	1.28%	1.19	%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs ⁽¹⁾	0.06 %	0.11%	0.08	%

(1) Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

	September 30,		December 31,	
	2018	2017	2017	
Nonperforming assets:				
Nonaccrual loans	\$220	\$7	\$6	
Restructured loans in nonaccrual	2,856	3,149	2,763	
Total nonperforming loans	3,076	3,156	2,769	
Other real estate owned, net	2,214	2,923	2,817	
Total nonperforming assets	\$5,290	\$6,079	\$5,586	
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	0.75 %	0.92 %	0.83 %	
Ratio of allowance for loan losses to nonperforming loans ⁽¹⁾	250.75 %	268.47 %	286.20 %	

⁽¹⁾ 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.

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

	September 30,		December	
	2018	2017	31,	2017
Loans past due 90 days or more and still accruing	\$63	\$250	\$ 51	
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees and costs	0.01	% 0.04	% 0.01	%
Accruing restructured loans	\$7,843	\$4,815	\$ 5,134	
Impaired loans:				
Impaired loans with no valuation allowance	\$10,530	\$10,522	\$ 10,444	
Impaired loans with a valuation allowance	1,404	1,637	1,480	
Total impaired loans	\$11,934	\$12,159	\$ 11,924	
Valuation allowance	(156)	(186)	(177)	
Impaired loans, net of allowance	\$11,778	\$11,973	\$ 11,747	
Average recorded investment in impaired loans ⁽¹⁾	\$12,684	\$12,541	\$ 13,344	
Interest income recognized on impaired loans, after designation as impaired	\$414	\$387	\$ 528	
Amount of income recognized on a cash basis	\$---	\$---	\$---	

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

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 nine months ended September 30, 2018 or September 30, 2017 or for the year ended December 31, 2017.

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

Impaired Loans as of September 30, 2018			
Principal Total	Recorded	Recorded	Related
Balance	Recorded	Investment⁽¹⁾for	Investment⁽¹⁾Allowance
	Investment⁽¹⁾	Which There is	for
		No	Which
			There is a

			Related Allowance	Related Allowance	
Real Estate Construction⁽²⁾					
Construction, other	\$2,470	\$ 2,470	\$ 2,470	\$ ---	\$ ---
Consumer Real Estate⁽²⁾					
Residential closed-end first liens	928	882	707	175	10
Residential closed-end junior liens	150	150	---	150	4
Investor-owned residential real estate	678	656	656	---	---
Commercial Real Estate⁽²⁾					
Multifamily	294	294	294	---	---
Commercial real estate, owner-occupied	3,529	3,520	3,520	---	---
Commercial real estate, other	3,152	2,796	2,796	---	---
Commercial Non Real Estate⁽²⁾					
Commercial and industrial	1,158	1,149	70	1,079	142
Consumer Non Real Estate⁽²⁾					
Automobile	17	17	17	---	---
Total	\$12,376	\$ 11,934	\$ 10,530	\$ 1,404	\$ 156

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

(2) Only classes with impaired loans are shown.

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Impaired Loans as of December 31, 2017					
	Principal Balance	Total Recorded Investment⁽¹⁾	Recorded Investment⁽¹⁾ for Which There is No Related Allowance	Recorded Investment⁽¹⁾ for Which There is a Related Allowance	Related Allowance
Real Estate Construction⁽²⁾					
Construction 1-4 family residential	\$2,882	\$ 2,882	\$ 2,882	\$ ---	\$ ---
Consumer Real Estate⁽²⁾					
Residential closed-end first liens	807	768	590	178	10
Residential closed-end junior liens	174	174	---	174	6
Investor-owned residential real estate	347	325	325	---	---
Commercial Real Estate⁽²⁾					
Multifamily real estate	303	303	303	---	---
Commercial real estate, owner occupied	3,619	3,611	3,611	---	---
Commercial real estate, other	2,921	2,602	2,602	---	---
Commercial Non Real Estate⁽²⁾					
Commercial and industrial	1,236	1,229	126	1,103	160
Consumer Non Real Estate⁽²⁾					
Automobile	30	30	5	25	1
Total	\$12,319	\$ 11,924	\$ 10,444	\$ 1,480	\$ 177

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

(2)Only classes with impaired loans are shown.

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

	For the Nine Months Ended	
	September 30, 2018	
	Average Interest	
	Recorded Income	
	Investment Recognized⁽¹⁾	
Real Estate Construction⁽²⁾		
Construction 1-4 family residential	\$2,697	\$ 108
Consumer Real Estate⁽²⁾		

Residential closed-end first liens	891	40
Residential closed-end junior liens	162	7
Investor-owned residential real estate	661	18
Commercial Real Estate⁽²⁾		
Multifamily real estate	298	12
Commercial real estate, owner occupied	3,934	145
Commercial real estate, other	2,829	55
Commercial Non Real Estate⁽²⁾		
Commercial and industrial	1,188	28
Consumer Non Real Estate⁽²⁾		
Automobile	24	1
Total	\$12,684	\$ 414

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

(2) Only classes with impaired loans are shown.

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	For the Nine Months Ended	
	September 30, 2017 Average Interest	
	Recorded Income	
	Investment⁽¹⁾ Recognized	
Real Estate Construction⁽²⁾		
Construction 1-4 family residential	\$3,323	\$ 133
Consumer Real Estate⁽²⁾		
Residential closed-end first liens	1,107	30
Residential closed-end junior liens	188	8
Investor-owned residential real estate	333	12
Commercial Real Estate⁽²⁾		
Multifamily real estate	310	12
Commercial real estate, owner occupied	3,420	140
Commercial real estate, other	2,658	45
Commercial Non Real Estate⁽²⁾		
Commercial and industrial	1,187	6
Consumer Non Real Estate		
Automobile	15	1
Total	\$12,541	\$ 387

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

(2) Only classes with impaired loans are shown.

	For the Year Ended	
	December 31, 2017 Average Interest	
	Recorded Income	
	Investment⁽¹⁾ Recognized	
Real Estate Construction⁽²⁾		
Construction 1-4 family residential	\$3,298	\$ 177
Consumer Real Estate⁽²⁾		
Residential closed-end first liens	781	57
Residential closed-end junior liens	185	11
Investor-owned residential real estate	329	1
Commercial Real Estate⁽²⁾		
Multifamily real estate	748	16

Commercial real estate, owner occupied	4,047	200
Commercial real estate, other	2,638	---
Commercial Non Real Estate⁽²⁾		
Commercial and industrial	1,282	64
Consumer Non Real Estate⁽²⁾		
Automobile	36	2
Total	\$13,344	\$ 528

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

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.

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An analysis of past due and nonaccrual loans follows.

September 30, 2018

	30 – 89 Days	90 or More	90 or More Days	Nonaccruals⁽²⁾
	Past Due and Accruing	Days Past Due	Past Due and Accruing	
Consumer Real Estate⁽¹⁾				
Equity lines	70	---	---	---
Residential closed-end first liens	1,388	63	38	163
Residential closed-end junior liens	12	---	---	---
Investor-owned residential real estate	54	---	---	200
Commercial Real Estate⁽¹⁾				
Multifamily real estate	294	195	---	195
Commercial real estate, owner-occupied	379	---	---	---
Commercial real estate, other	---	2,510	---	2,510
Commercial Non Real Estate⁽¹⁾				
Commercial and industrial	196	---	---	8
Consumer Non Real Estate⁽¹⁾				
Credit cards	7	5	5	---
Automobile	322	10	10	---
Other consumer loans	46	10	10	---
Total	\$ 2,768	\$2,793	\$ 63	\$ 3,076

(1) Only classes with past-due or nonaccrual loans are shown.

(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

December 31, 2017

	30 – 89 Days	90 or More	90 or More Days	Nonaccruals⁽²⁾
	Past Due and Accruing	Days Past Due	Days Past Due and Accruing	
Consumer Real Estate⁽¹⁾				
Residential closed-end first liens	\$ 637	\$16	\$ 11	\$ 145

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

(1) Only classes with past-due or nonaccrual loans are shown.

(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

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

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

Determination of risk grades was completed for the portfolio as of September 30, 2018 and December 31, 2017.

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

September 30, 2018

	Pass⁽¹⁾	Special	
		Mention⁽¹⁾	Classified⁽¹⁾
Real Estate Construction			
Construction, 1-4 family residential	\$9,281	\$ ---	\$ ---
Construction, other	30,776	21	---
Consumer Real Estate			
Equity lines	16,653	296	---
Closed-end first liens	87,835	916	590
Closed-end junior liens	4,059	---	---
Investor-owned residential real estate	59,642	---	---
Commercial Real Estate			
Multifamily residential real estate	93,296	---	195
Commercial real estate owner-occupied	122,589	74	32
Commercial real estate, other	123,960	---	---
Commercial Non Real Estate			
Commercial and industrial	43,176	167	5
Public Sector and IDA			
States and political subdivisions	59,369	---	---
Consumer Non Real Estate			
Credit cards	5,564	---	---
Automobile	15,912	78	49
Other consumer	15,934	24	9
Total	\$688,046	\$ 1,576	\$ 880

(1) Excludes impaired, if any.

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

December 31, 2017

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

⁽¹⁾ 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 major reclassifications from portfolio loans to held for sale. Occasionally, the Company purchases or sells participations in loans. All participation loans purchased met the Company’s normal underwriting standards at the time the participation was entered. Participation loans are included in the appropriate portfolio balances to which the allowance methodology is applied.

Troubled Debt Restructurings

From time to time the Company modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to \$10,700 at September 30, 2018, \$7,897 at December 31, 2017, and \$7,964 at September 30, 2017.

The following table presents restructurings by class that occurred during the three month period ended September 30, 2018.

**Restructurings That Occurred During
the Three Months**

Ended September 30, 2018

	Pre-Modification Number of Outstanding	Post-Modification Outstanding
	Principal Balance	Principal Balance
Residential Real Estate		
Investor owned real estate	2 \$ 338	\$ 338
Total	2 \$ 338	\$ 338

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The restructurings completed during the three-month period ended September 30, 2018 provided payment relief to the borrowers without forgiving principal or interest. One loan was restructured to provide for a 12-month interest-only period, after which the loan will be re-evaluated. The impairment measurement was based on the fair value of collateral and did not result in a specific allocation. The second restructure consolidated debt at a longer term, provided a rate reduction for certain of the loans consolidated but increased the interest rate on certain other loans consolidated, and capitalized interest. The impairment measurement was based upon the present value of cash flows and did not result in a specific allocation.

The following table presents restructurings by class that occurred during the nine month period ended September 30, 2018.

	Restructurings That Occurred During the Nine Months	
	Ended September 30, 2018	
	Pre-Modification Number of Outstanding	Post-Modification Outstanding
	Principal Balance	Principal Balance
Real Estate Construction		
Construction, other	2 \$ 2,882	\$ 2,882
Residential Real Estate		
Investor owned real estate	2 338	338
Commercial Real Estate		
Commercial real estate owner-occupied	2 715	715
Total	6 \$ 3,935	\$ 3,935

The Company restructured six loans during the nine month period ended September 30, 2018. Each of the construction loans were restructured to extend the maturity and interest only period. Impairment measurements were based on the fair value of the collateral and did not result in a specific allocation.

One of the investor owned real estate loans was restructured to provide for a 12-month interest-only period, after which the loan will be reevaluated. The impairment measurement was based on the fair value of collateral and did not result in a specific allocation. The second investor owned residential real estate loan consolidated debt at a longer term, provided a rate reduction for certain of the loans consolidated but increased the interest rate on certain other loans consolidated, and capitalized interest. The impairment measurement was based upon the present value of cash flows and did not result in a specific allocation.

Two commercial real estate loans were restructured to provide a 12-month interest-only period. When the interest-only period expires, the commercial real estate loans will be re-amortized for a longer term. The impairment measurements were based upon the present value of cash flows and did not result in a specific allocation for either

loan.

The following table present restructurings by class that occurred during the three month period ended September 30, 2017.

Restructurings That Occurred During the Three Months		
Ended September 30, 2017		
	Pre-Modification Number of Outstanding	Post-Modification Outstanding
	Principal Balance	Principal Balance
Commercial Non Real Estate		
Commercial and industrial	2 \$ 1,116	\$ 1,116
Consumer Non Real Estate		
Automobile	2 14	14
Total	4 \$ 1,130	\$ 1,130

Each of the restructurings completed during the three-month period ended September 30, 2017 provided payment relief to the borrowers without forgiving principal or interest. The two commercial non-real estate loans were restructured to reduce monthly debt service by increasing the amortization period and reducing the rate. Impairment measurement, based on the present value of cash flows, indicated a specific reserve for each of the commercial non-real estate loans. The two automobile loans were restructured pursuant to Chapter 13 bankruptcy requirements, reducing the interest rate and re-amortizing over a longer term to provide monthly debt service relief. Impairment measurement was based on the present value of cash flows method and resulted in specific allocations for each loan.

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The following table presents restructurings by class that occurred during the nine month period ending September 30, 2017.

Restructurings That Occurred During the Nine Months		
Ended September 30, 2017		
	Pre-Modification Number of Outstanding	Post-Modification Outstanding
	Principal Balance	Principal Balance
Commercial Real Estate		
Commercial real estate, owner occupied	1 \$ 132	\$ 132
Commercial Non Real Estate		
Commercial and industrial	4 1,234	1,234
Consumer Non Real Estate		
Automobile	2 14	14
Total	7 \$ 1,380	\$ 1,380

Each of the restructurings completed during the nine-month period ended September 30, 2017 provided payment relief to the borrowers without forgiving principal or interest. The commercial real estate loan was restructured to reduce monthly debt service by lowering the interest rate and changing the interest method from variable to fixed. Interest was capitalized and the loan was re-amortized over a longer term. Impairment measurement, based on the present value of cash flows, did not result in a specific allocation. The loan is in nonaccrual status and all payments made during the nonaccrual period are credited fully to principal, reducing the book balance below the present value of cash flows. The four commercial non-real estate loans were restructured to reduce monthly debt service by increasing the amortization period. Three of the commercial non-real estate loans received rate reductions, and the interest method on one commercial non-real estate loan was changed from variable to fixed. Impairment measurement, based on the present value of cash flows, indicated a specific reserve for two of the commercial non-real estate loans. The two automobile loans were restructured pursuant to Chapter 13 bankruptcy requirements, reducing the interest rate and re-amortizing over a longer term to provide monthly debt service relief. Impairment measurement was based on the present value of cash flows method and resulted in specific allocations for each loan.

The Company analyzed its TDR portfolio for loans that defaulted during the three and nine month periods ended September 30, 2018 and September 30, 2017, and that were modified within 12 months prior to default. For these purposes, 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 nine month periods ended September 30, 2018 and September 30, 2017, 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.

	September 30, 2018			
	Amortized	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
Available for Sale:	Costs			
U.S. Government agencies and corporations	\$329,455	\$ 267	\$ 9,751	\$319,971
States and political subdivisions	121,515	1,272	1,704	121,083
Mortgage-backed securities	632	47	---	679
Corporate debt securities	7,003	14	265	6,752
Total securities available for sale	\$458,605	\$ 1,600	\$ 11,720	\$448,485

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

The amortized cost and fair value of single maturity securities available for sale at September 30, 2018, 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.

	September 30, 2018	
	Amortized Cost	Fair Value
Available for Sale:		
Due in one year or less	\$81,642	\$81,455
Due after one year through five years	184,604	179,518
Due after five years through ten years	97,187	94,744
Due after ten years	95,172	92,768
Total securities available for sale	\$458,605	\$448,485

Prior to the second quarter of 2018, the Company designated securities in its portfolio as either available for sale or held to maturity. During the second quarter of 2018, the Company re-designated all of its held to maturity securities to available for sale. The securities were re-designated to provide opportunities to maximize asset utilization. At the time of transfer, the securities had a fair value of \$119,790 and an amortized cost of \$118,662, resulting in an unrealized gain of \$1,128 which was added to accumulated other comprehensive income.

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The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity as of December 31, 2017 by major security type are as follows.

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

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.

	September 30, 2018			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Temporarily Impaired Securities:				
U.S. Government agencies and corporations	\$68,197	\$ 2,570	\$244,485	\$ 7,181
States and political subdivisions	42,422	1,293	5,514	411
Corporate debt securities	4,870	164	877	101
Total	\$115,489	\$ 4,027	\$250,876	\$ 7,693

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

The Company had 413 securities with a fair value of \$366,365 that were temporarily impaired at September 30, 2018. The total unrealized loss on these securities was \$11,720. Of the temporarily impaired total, 263 securities with a fair value of \$250,876 and an unrealized loss of \$7,693 have been in a continuous loss position for twelve months or

more. The Company has determined that these securities are temporarily impaired at September 30, 2018 for the reasons set out below.

U.S. Government agencies. The unrealized losses of \$7,181 on US Government agency securities stemmed from 252 securities with a fair value of \$244,485. The unrealized losses were caused by interest rate and market fluctuations. The contractual term of the investment does not permit the issuer to settle the security at a price less than the cost basis of the investment. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of the 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 \$411 on 10 securities with a fair value of \$5,514 is primarily the result of interest rate and market fluctuations. The Company reviewed financial statements and cash flows for each of the securities in continuous loss position for more than 12 months. The Company's analysis determined that the unrealized losses are primarily the result of interest rate and market fluctuations and not associated with impaired financial status. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

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Corporate debt securities. The unrealized loss of \$101 on one corporate debt security with a fair value of \$877 was caused by market and interest rate fluctuations and is not associated with impaired financial status. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell the investment and it is not likely that the Company will be required to sell the investment before recovery of its amortized cost basis, which may be at maturity, the Company does not consider the investment to be other-than-temporarily impaired.

Restricted stock. The Company held restricted stock of \$2,708 as of September 30, 2018 and \$1,200 as of December 31, 2017. Restricted stock is reported separately from available-for-sale securities and held-to-maturity securities. As a member of the Federal Reserve and the Federal Home Loan Bank (“FHLB”) of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB’s capital, current borrowings, and a percentage of qualifying assets. The Company purchases stock from or sells stock back to the correspondents based on their calculations. The stock is held by member institutions only and is not actively traded.

Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. In addition to dividends, NBB also benefits from its membership with FHLB through eligibility to borrow from the FHLB, using as collateral NBB’s capital stock investment in the FHLB and qualifying NBB real estate mortgage loans totaling \$503,690 at September 30, 2018. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at September 30, 2018, 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 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 FASB made subsequent amendments to Topic 842 in July 2018 through ASU 2018-10 (“Codification Improvements to Topic 842, Leases.”) and ASU 2018-11 (“Leases (Topic 842): Targeted Improvements.”) Among these amendments is the provision in ASU 2018-11 that provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption

date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases). The Company is currently assessing the impact that ASU 2016-02 (as amended) will have on its consolidated financial statements. The Company is the lessee of six banking locations and one ATM location. At the effective date, the Company will recognize a lease liability and a right-of-use asset for each of the leases. Pro-forma analysis based on current lease contracts indicates that the lease liability and the right-of-use asset are similar in amount, with only nominal difference.

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

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In 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.

In 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 adoption of ASU 2017-08 will have on its consolidated financial statements, but does not expect a material impact.

In June 2018, the FASB issued ASU 2018-07, “Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.” The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-14, “Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans.” These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. Certain disclosure requirements have been deleted while the following disclosure requirements have been added: the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates and an explanation of the reasons for significant gains and losses related to changes in the

benefit obligation for the period. The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed: The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets. The amendments are effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-14 to have a material impact on its consolidated financial statements.

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	Pension Benefits Nine Months Ended September 30, 2018 2017	
Service cost	\$651	\$519
Interest cost	600	558
Expected return on plan assets	(1,200)	(822)
Amortization of prior service cost	(81)	(81)
Recognized net actuarial loss	438	405
Net periodic benefit cost	\$408	\$579

The service cost component of net periodic benefit cost is included in salaries and employee benefits expense in the consolidated statements of income. All other components are included in other noninterest expense in the consolidated statements of income.

2018 Plan Year Employer Contribution

For the nine months ended September 30, 2018, the Company did not make a contribution to the Plan.

Note 7: Fair Value Measurements

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

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

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

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

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

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

Securities Available for Sale

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

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The following tables present the balances of financial assets measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017.

Description	Balance as of September 30, 2018	Fair Value Measurements at September 30, 2018 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	\$ 319,971	\$---	\$ 319,971	\$ ---
States and political subdivisions	121,083	---	121,083	---
Mortgage-backed securities	679	---	679	---
Corporate debt securities	6,752	---	6,752	---
Total securities available for sale	\$ 448,485	\$---	\$ 448,485	\$ ---

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

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 are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at September 30, 2018 or December 31, 2017.

Impaired Loans

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

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

Loans measured using the fair value of collateral 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. The Company uses an evaluation to measure fair value of collateral for impaired loans with principal balances below \$100, or if secured by multiple pieces of collateral, below \$250.

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

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at September 30, 2018 and at December 31, 2017.

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:				
September 30, 2018	Impaired loans net of valuation allowance	\$ 1,248	\$---	\$ ---	\$ 1,248
December 31, 2017	Impaired loans net of valuation allowance	1,303	---	---	1,303

The following tables present information about Level 3 Fair Value Measurements for September 30, 2018 and December 31, 2017.

Impaired Loans	Valuation Technique	Unobservable Input	Range
			(Weighted Average)
September 30, 2018	Present value of cash flows	Discount rate	5.50% - 7.25% (6.04%)
December 31, 2017	Present value of cash flows	Discount rate	5.50% - 43.25% (5.92%)

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. Valuation of other real estate owned is determined using current appraisals from independent parties, a Level 2 input. If current appraisals cannot be obtained prior to reporting dates, or if declines in value are identified after a recent appraisal is received, appraisal values are discounted, resulting in Level 3 estimates. If the Company markets the property with a realtor, estimated selling costs reduce the fair value, resulting in a valuation based on Level 3 inputs.

The following table summarizes the Company's other real estate owned that 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:					
September 30, 2018	Other real estate owned net of valuation allowance	\$ 2,214	\$---	\$ ---	\$ 2,214
December 31, 2017	Other real estate owned net of valuation allowance	2,817	---	---	2,817

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The following tables present information about Level 3 Fair Value Measurements for September 30, 2018 and December 31, 2017.

September 30, 2018		Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value		Selling cost	5.00% -6.81% (5.75%)
Other real estate owned	Discounted appraised value		Discount for lack of marketability and age of appraisal	3.19% -37.80% (13.40%)
December 31, 2017		Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value		Selling cost	2.00%-6.01% (4.72%)
Other real estate owned	Discounted appraised value		Discount for lack of marketability and age of appraisal	1.68%-68.33% (11.07%)

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2018 and December 31, 2017. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities such as Federal Home Loan Bank and Federal Reserve Bank stock, the carrying amount is a reasonable estimate of fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government-supported institution or to another member institution. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity. Fair values for September 30, 2018 are estimated under the exit price notion in accordance with the prospective adoption of ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." Fair values for December 31, 2017 are estimated under the guidance in effect for that period, which did not require use of the exit price notion.

September 30, 2018			
Carrying Amount	Quoted Prices in Active Markets for	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 2	Level 3

**Identical
Assets**

Level 1

Financial Assets:

Cash and due from banks	\$ 11,533	\$ 11,533	\$ ---	\$ ---
Interest-bearing deposits	28,328	28,328	---	---
Securities	448,485	---	448,485	---
Restricted securities	2,708	---	2,708	---
Loans held for sale	1,027	---	1,027	---
Loans, net	694,121	---	---	681,301
Accrued interest receivable	5,589	---	5,589	---
Bank-owned life insurance	34,434	---	34,434	---
Financial Liabilities:				
Deposits	\$ 1,022,176	\$ ---	\$ 926,009	\$ 96,165
Accrued interest payable	165	---	165	---
Borrowings	35,000	---	34,998	---

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	December 31, 2017			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Financial Assets:				
Cash and due from banks	\$ 12,926	\$ 12,926	\$ ---	\$ ---
Interest-bearing deposits	51,233	51,233	---	---
Securities	458,551	---	461,500	---
Restricted securities	1,200	---	1,200	---
Loans held for sale	260	---	260	---
Loans, net	660,144	---	---	656,399
Accrued interest receivable	5,297	---	5,297	---
Bank-owned life insurance	33,756	---	33,756	---
Financial Liabilities:				
Deposits	\$ 1,059,734	\$ ---	\$ 944,850	\$ 113,053
Accrued interest payable	62	---	62	---

Note 8: Components of Accumulated Other Comprehensive Loss

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
Balance at December 31, 2016	\$ (3,588)	\$ (5,071)	\$ (8,659)
Unrealized holding gain on available for sale securities, net of tax of \$1,235	2,294	---	2,294
Reclassification adjustment, net of tax of (\$1)	(3)	---	(3)
Balance at September 30, 2017	\$ (1,297)	\$ (5,071)	\$ (6,368)
Balance at December 31, 2017	\$ (3,704)	\$ (5,991)	\$ (9,695)
Unrealized holding loss on available for sale securities net of tax of (\$1,378)	(5,182)	---	(5,182)
Unrealized holding gain on securities transferred from held to maturity to available for sale, net of tax of \$237	891	---	891
Balance at September 30, 2018	\$ (7,995)	\$ (5,991)	\$ (13,986)

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Note 9: Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 “Revenue from Contracts with Customers” (Topic 606) and all subsequent ASUs that modified Topic 606. As stated in Note 1 Summary of Significant Accounting Policies, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue. Results for reporting periods beginning after January 1, 2018 and comparative periods are presented under Topic 606.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as financial guarantees, derivatives, and certain credit card fees are outside the scope of the guidance. Topic 606 is applicable to noninterest revenue streams such as service charges on deposit accounts, other service charges and fees, credit and debit card fees, trust income, and annuity and insurance commissions. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company’s revenue is generated from contracts with customers. Noninterest revenue streams within the scope of Topic 606 are discussed below.

Service Charges on Deposit Accounts

Service charges on deposit accounts consist of monthly service fees, overdraft and nonsufficient funds fees, ATM fees, wire transfer fees, and other deposit account related fees. The Company’s performance obligation for monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers’ accounts. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Wire transfer fees, overdraft and nonsufficient funds fees and other deposit account related fees are transactional based, and therefore, the Company’s performance obligation is satisfied, and related revenue recognized, at a point in time.

Other Service Charges

Other service charges include safety deposit box rental fees, check ordering charges, and other service charges. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation. Check ordering charges are transactional based, and therefore, the Company’s performance obligation is satisfied, and related revenue recognized, at a point in time.

Credit and Debit Card Fees

Credit and debit card fees are primarily comprised of interchange fee income and merchant services income. Interchange fees are earned whenever the Company’s debit and credit cards are processed through card payment networks such as Visa. Merchant services income mainly represents fees charged to merchants to process their debit

and credit card transactions, in addition to account management fees. The Company's performance obligation for interchange fee income and merchant services income are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. In compliance with Topic 606, credit and debit card fee income is presented net of associated expense.

Trust Income

Trust income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives. Estate management fees are based upon the size of the estate. A partial fee is recognized half-way through the estate administration and the remainder of the fee is recognized when remaining assets are distributed and the estate is closed.

Insurance and Investment

Insurance income primarily consists of commissions received on insurance product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the insurance policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue.

Investment income consists of recurring revenue streams such as commissions from sales of mutual funds and other investments. Commissions from the sale of mutual funds and other investments are recognized on trade date, which is when the Company has satisfied its performance obligation. The Company also receives periodic service fees (i.e., trailers) from mutual fund companies typically based on a percentage of net asset value. Trailer revenue is recorded over time, usually monthly or quarterly, as net asset value is determined.

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The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the nine months ended September 30, 2018 and 2017.

	September 30, 2018	September 30, 2017
Noninterest Income		
<i>In-scope of Topic 606:</i>		
Service charges on deposit accounts	\$ 2,037	\$ 2,067
Other service charges and fees	87	152
Credit and debit card fees	1,071	854
Trust income	1,131	1,127
Insurance and Investment (included within Other Income on the Consolidated Statements of Income)	361	284
Noninterest Income (in-scope of Topic 606)	\$ 4,687	\$ 4,484
Noninterest Income (out-of-scope of Topic 606)	1,118	981
Total noninterest income	\$ 5,805	\$ 5,465

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

Dollars 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 2017 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-Q that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management's views and assumptions as of the date of this report. The words "believes," "expects," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends," or other similar words or terms are intended to identify forward-looking statements.

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

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

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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 the most recently filed Form 10-K.

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

Cybersecurity

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

Critical Accounting Policies

General

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

Allowance for Loan Losses

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

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

Impaired loans

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

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

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

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

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

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

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

Collectively-evaluated loans

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

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

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

non-classified loan balances, and classified historical loss rates are applied to collectively-evaluated classified loan balances.

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

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

Estimation of the allowance for loan losses

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

The estimate of the allowance for September 30, 2018 considered market and portfolio conditions during the first nine months of 2018 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended September 30, 2018. If the economy experiences a downturn, 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."

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Goodwill

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

Certain key judgments were used in the valuation measurement. Goodwill is held by the Company's bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company's assets are comprised of the subsidiary bank's equity, the Company's market capitalization was used to estimate the Bank's market capitalization. Other judgments include the assumption that the companies and transactions used as comparable properties 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. (the "Company" or "NBI") is a financial holding company that was organized in 1986 under the laws of Virginia and is registered under the Bank Holding Company Act of 1956. It conducts most of its operations through its wholly-owned community bank subsidiary, the National Bank of Blacksburg ("NBB"). It also owns National Bankshares Financial Services, Inc. ("NBFS"), which does business as National Bankshares Insurance Services and National Bankshares Investment Services.

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 September 29, 2009.

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Lending

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

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

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

The Bank's loan policy is updated and approved by the Board of Directors annually, and disseminated to lending and loan portfolio management personnel to ensure consistent lending practices. The policy communicates the Company's risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy, documentation standards, requirements for collateral and loan-to-value limits, debt coverage and overall credit-worthiness, and guarantor support.

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

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

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

include retail centers, office space, apartments and industrial properties.

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

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

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

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

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

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

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

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

Performance Summary

The following table presents the Company's key performance ratios for the three months ended September 30, 2018 and September 30, 2017. The measures for September 30, 2018 and September 30, 2017 are annualized, except for basic earnings per share and fully diluted earnings per share.

Three Months Ended	Three Months Ended
-----------------------------------	-----------------------------------

	September 30, 2018		September 30, 2017	
Return on average assets ⁽¹⁾	1.34	%	1.22	%
Return on average equity ⁽¹⁾	8.97	%	8.07	%
Basic earnings per share	\$ 0.61		\$ 0.54	
Fully diluted earnings per share	\$ 0.61		\$ 0.54	
Net interest margin ⁽²⁾	3.38	%	3.44	%
Noninterest margin ⁽³⁾	1.44	%	1.33	%

(1) The return on average assets and return on average equity are calculated by annualizing net income to date.

(2) Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

(3) Noninterest margin: Noninterest expense (excluding non-recurring items, the provision for loan losses and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The annualized return on average assets increased 12 basis points for the three months ended September 30, 2018 compared with the three months ended September 30, 2017. The annualized return on average equity increased 90 basis points when the same periods are compared.

The annualized net interest margin was 3.38% for the three months ended September 30, 2018, down 6 basis points from the 3.44% reported for the three months ended September 30, 2017. The primary factor driving the decrease in the net interest margin was the decrease in income from nontaxable securities. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin worsened by 11 basis points when compared with the three month period ended September 30, 2017. Please refer to the discussions under noninterest income and noninterest expense for further information

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The following table presents the Company's key performance ratios for the nine months ended September 30, 2018 and September 30, 2017 and the year ended December 31, 2017. The measures for September 30, 2018 and September 30, 2017 are annualized, except for basic earnings per share and fully diluted earnings per share.

	Nine Months Ended		Nine Months Ended		Twelve Months Ended	
	September 30, 2018		September 30, 2017		December 31, 2017	
Return on average assets ⁽¹⁾	1.28	%	1.19	%	1.14	%
Return on average equity ⁽¹⁾	8.61	%	8.02	%	7.64	%
Basic earnings per share	\$ 1.67		\$ 1.58		\$ 2.03	
Fully diluted earnings per share	\$ 1.67		\$ 1.58		\$ 2.03	
Net interest margin ⁽²⁾	3.37	%	3.45	%	3.45	%
Noninterest margin ⁽³⁾	1.41	%	1.39	%	1.34	%

(1) The return on average assets and return on average equity are calculated by annualizing net income to date. For 2018, the annualization factor was not applied to the insurance write-off.

(2) Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.

(3) Noninterest margin: Noninterest expense (excluding non-recurring items, the provision for loan losses and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The annualized return on average assets increased 9 basis points for the nine months ended September 30, 2018 compared with the nine months ended September 30, 2017 and increased 14 basis points compared with the twelve months ended December 31, 2017.

The annualized return on average equity was 8.61% for the nine months ended September 30, 2018, an increase from 8.02% for the nine month period ended September 30, 2017 and 7.64% for the twelve month period ended December 31, 2017.

The annualized net interest margin was 3.37% for the nine months ended September 30, 2018, down 8 basis points from the 3.45% reported for the nine months ended September 30, 2017 and for the twelve months ended December 31, 2017. The primary factor driving the decrease in the net interest margin was the decrease in income from nontaxable securities. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin worsened by 2 basis points when compared with 1.39% for the nine month period ended September 30, 2017 and worsened by 7 basis points when compared with 1.34% for the twelve months ended December 31, 2017. Please refer to the discussions under noninterest income and noninterest expense for further information

The following table details the calculation of annualized net income for the return on average assets and the return on average equity:

	Nine Months Ended	Nine Months Ended
	September 30, 2018	September 30, 2017
Net Income	\$ 11,588	\$ 11,004
Items deemed non-recurring by management:		
Insurance write-down, net of tax of \$422	1,588	---
Adjusted net income	13,176	11,004
Adjusted net income, annualized	17,616	14,712
Items deemed non-recurring by management:		
Insurance write-down, net of tax of (\$422)	(1,588)	---
Annualized net income for ratio calculation	\$ 16,028	\$ 14,712

Table of Contents**Growth**

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

	September 30, 2018	December 31, 2017	Percent Change	
Interest-bearing deposits	\$28,328	\$51,233	(44.71)	%
Securities and restricted stock	451,193	459,751	(1.86)	%
Loans, net	694,121	660,144	5.15	%
Deposits	1,022,176	1,059,734	(3.54)	%
Total assets	1,258,289	1,256,757	0.12	%

Asset Quality

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

	September 30, 2018	September 30, 2017	December 31, 2017		
Nonperforming loans	\$ 3,076	\$ 3,156	\$ 2,769		
Loans past due 90 days or more, and still accruing	63	250	51		
Other real estate owned	2,214	2,923	2,817		
Allowance for loan losses to loans	1.10	% 1.28	% 1.19	%	%
Net charge-off ratio	0.06	% 0.11	% 0.08	%	%
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	0.75	% 0.92	% 0.83	%	%
Ratio of allowance for loan losses to nonperforming loans	250.75	% 268.47	% 286.20	%	%

The Company's risk analysis at September 30, 2018 determined an allowance for loan losses of \$7,713 or 1.10% of loans net of unearned income and deferred fees and costs, a decrease from \$7,925 or 1.19% at December 31, 2017. The determination of the appropriate level for the allowance for loan losses resulted in a provision of \$93 for the nine months ended September 30, 2018, compared with a provision of \$724 for the nine months ended September 30, 2017 and a provision for the twelve month period ended December 31, 2017 of \$157. The provision for the three-month periods ended September 30, 2018 and September 30, 2017 totaled \$223 and \$201, respectively. To determine the appropriate level of the allowance for loan losses, the Company considers credit risk for certain loans designated as impaired and for non-impaired ("collectively evaluated") loans.

Individually evaluated impaired loans totaled \$11,934 on a gross basis and \$11,930 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses totaling \$156 at September 30, 2018.

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

Collectively evaluated loans totaled \$690,502 on a gross basis and \$689,904 net of unearned income and deferred fees and costs, with an allowance of \$7,557 or 1.10% at September 30, 2018. At December 31, 2017, collectively evaluated loans totaled \$656,758 on a gross basis and \$656,150 net of unearned income and deferred fees and costs, with an allowance of \$7,748 or 1.18%.

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

Net charge-off rates for each class are averaged over 8 quarters (2 years) to determine the historical net charge off rate applied to each class of collectively evaluated loans. Net charge-offs for the nine months ended September 30, 2018 were \$305 or 0.06% (annualized) of average loans, an improvement from \$551 or 0.11% (annualized) for the nine months ended September 30, 2017. Net charge-offs for the twelve months ended December 31, 2017 were \$532 or 0.08% of loans. The 8-quarter average historical loss rate applied to the calculation was 0.10% for September 30, 2018, 0.26% for September 30, 2017 and 0.17% for December 31, 2017. 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.

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

Within the Company's market area, the unemployment, business bankruptcies and the residential vacancy rate improved from December 31, 2017. The competitive, legal and regulatory environments and the inventory of homes remained at similar levels to December 31, 2017. Personal bankruptcies worsened slightly when compared to last quarter and December 31, 2017. Interest rates increased from December 31, 2017.

The Company considers other factors that impact credit risk, including the risk from changes in the legal and regulatory environments, changes to lending policies and loan review, and changes in management's experience. Each of the factors remained at similar levels to December 31, 2017. Management examined the allocation to the allowance for the risk from changes in the loan review system. Management deemed that the risk from changes allocated in prior years would now be reflected in the historical loss rates and removed the allocation.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.39% of total loans, net of unearned income and deferred fees and costs at September 30, 2018, an increase from 0.34% at December 31, 2017 and 0.39% at September 30, 2017. Accruing loans past due 90 days or more were 0.01% of total loans, net of unearned income and deferred fees and costs at September 30, 2018, the same level as December 31, 2017 and a decrease from 0.04% at September 30, 2017. Nonaccrual loans at September 30, 2018 were 0.44% of total loans, net of unearned income and deferred fees and costs, 0.41% at December 31, 2017 and 0.48% at September 30, 2017. 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.

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 rose \$9,598 or 6.16% from the level at December 31, 2017, resulting in an increased allocation.

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 \$1,576 at September 30, 2018, \$3,361 at December 31, 2017 and \$2,349 at September 30, 2017. Collectively evaluated loans rated classified were \$880 at September 30, 2018, \$1,691 at December 31, 2017 and \$2,532 at September 30, 2017. The improvements in levels of criticized assets

resulted in lower allocations.

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 September 30, 2018 is 1.10%, a decrease from 1.19% at December 31, 2017. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.10%, compared with 1.18% at December 31, 2017. Improvements from December 31, 2017 in the charge-off rate, unemployment, business bankruptcy rate, residential vacancy, and criticized loans decreased the required level of the allowance for loan losses, slightly offset by worsening in nonaccrual loans, loans past due 30-89 days and the impact of the interest rate environment. Based on analysis of historical indicators, asset quality and economic factors, management believes the level of allowance for loan losses is reasonable for the credit risk in the loan portfolio.

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

Other Real Estate Owned⁽¹⁾	September 30, 2018	September 30, 2017	December 31, 2017
Real estate construction	\$ 2,012	\$ 2,425	\$ 2,425
Consumer real estate	12	42	42
Commercial real estate	190	456	350
Total other real estate owned	\$ 2,214	\$ 2,923	\$ 2,817
Loans in process of foreclosure	\$ 1,012	\$ 649	\$ 11

(1) Net of valuation allowance.

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Other real estate owned decreased \$603 from December 31, 2017 and \$709 from September 30, 2017. As of September 30, 2018, loans secured by residential real estate totaling \$818 and loans secured by commercial real estate of \$194 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 experiencing consequences of a specific unforeseen temporary hardship.

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

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

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

Nine Months Ended September 30, 2018

Modifications To Borrowers Not Experiencing Financial Difficulty	Number of Loans Modified	Amount Modified (in thousands)
Rate reductions for competitive purposes	8	\$ 2,371
Payment extensions for less than 3 months	39	451
Maturity date extensions of more than 3 months and up to 6 months	98	15,533

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Maturity date extensions of more than 6 months and up to 12 months	237	8,618
Maturity date extensions of more than 12 months	12	1,600
Advances on non-revolving loans or capitalization	7	1,845
Change in amortization term or method	7	965
Change or release of collateral	38	568
Renewal of expired Home Equity Line of Credit loans for additional 10 years	10	153
Renewal of single-payment notes	110	2,344
Total modifications that do not constitute TDRs	566	\$ 34,448

Table of Contents**Nine Months Ended September 30, 2017**

Modifications To Borrowers Not Experiencing Financial Difficulty	Number of Loans Modified	Amount Modified (in thousands)
Rate reductions for competitive purposes	23	\$ 7,568
Payment extensions for less than 3 months	87	1,857
Maturity date extensions of more than 3 months and up to 6 months	147	23,488
Maturity date extensions of more than 6 months and up to 12 months	239	9,928
Maturity date extensions of more than 12 months	5	3,365
Advances on non-revolving loans or capitalization	12	4,603
Change in amortization term or method	31	3,901
Renewal of expired Home Equity Line of Credit loans for additional 10 years	12	358
Renewal of single-payment notes	187	4,130
Total modifications that do not constitute TDRs	743	\$ 59,198

Twelve Months Ended December 31, 2017

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

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

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

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

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

The Company's TDRs were \$10,700 at September 30, 2018, an increase from \$7,897 at December 31, 2017. Accruing TDR loans amounted to \$7,843 at September 30, 2018 and \$5,134 at December 31, 2017. TDRs with at least six months of current payment history may accrue interest.

Table of Contents**TDR Status as of September 30, 2018**

	Total TDR	Accruing			Nonaccrual
		Current	30-89	90+	
			Days	Days	
Loans		Past Due	Past Due		
Real estate construction	\$2,470	\$2,470	\$ ---	\$ ---	\$ ---
Consumer real estate	1,382	1,044	---	---	338
Commercial real estate	5,683	3,173	---	---	2,510
Commercial non real estate	1,149	1,141	---	---	8
Consumer non real estate	16	12	4	---	---
Total TDR Loans	\$10,700	\$7,840	\$ 4	\$ ---	\$ 2,856

TDR Status as of December 31, 2017

	Total TDR	Accruing			Nonaccrual
		Current	30-89	90+	
			Days	Days	
Loans		Past Due	Past Due		
Real estate construction	\$---	\$---	\$---	\$---	\$---
Consumer real estate	1,092	773	174	---	145
Commercial real estate	5,550	2,948	---	---	2,602
Commercial non real estate	1,229	1,214	---	---	15
Consumer non real estate	26	25	---	---	1
Total TDR Loans	\$7,897	\$4,960	\$ 174	\$ ---	\$ 2,763

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 six loans during the nine month period ended September 30, 2018 and modified seven loans during the nine month period ended September 30, 2017. Please refer to Note 3 for information on troubled debt restructurings.

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The net interest income analysis for the three and nine months ended September 30, 2018 and 2017 follows:

	Three Months Ended September 30, 2018			September 30, 2017				
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate		
Interest-earning assets:								
Loans, net ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾	\$694,590	\$8,115	4.64	% \$651,492	\$7,632	4.65	%	
Taxable securities ⁽⁵⁾⁽⁶⁾	348,582	1,771	2.02	% 313,274	1,426	1.81	%	
Nontaxable securities ⁽¹⁾⁽⁵⁾	120,615	1,344	4.42	% 128,294	1,821	5.63	%	
Interest-bearing deposits	22,432	111	1.96	% 69,994	224	1.27	%	
Total interest-earning assets	\$1,186,219	\$11,341	3.79	% \$1,163,054	\$11,103	3.79	%	
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$598,864	\$982	0.65	% \$595,273	\$830	0.55	%	
Savings deposits	140,923	52	0.15	% 140,267	61	0.17	%	
Time deposits	100,534	107	0.42	% 120,237	130	0.43	%	
Borrowings	15,978	104	2.58	% ---	---	---	%	
Total interest-bearing liabilities	\$856,299	\$1,245	0.58	% \$855,777	\$1,021	0.47	%	
Net interest income and interest rate spread		\$10,096	3.21	%	\$10,082	3.32	%	
Net yield on average interest-earning assets			3.38	%		3.44	%	

Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21% for the three month period ended September 30, 2018 and 35% for the three month period ended September 30, 2017.

⁽²⁾ Included in interest income are loan fees of \$30 and \$62 for the three months ended September 30, 2018 and 2017, 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.

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	Nine Months Ended September 30, 2018			September 30, 2017				
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate		
Interest-earning assets:								
Loans, net ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾	\$677,110	\$23,452	4.63	% \$651,208	\$22,865	4.69	%	
Taxable securities ⁽⁵⁾⁽⁶⁾	343,661	5,125	1.99	% 311,090	4,225	1.82	%	
Nontaxable securities ⁽¹⁾⁽⁵⁾	126,486	4,271	4.51	% 133,532	5,608	5.70	%	
Interest-bearing deposits	39,366	509	1.73	% 76,661	603	1.05	%	
Total interest-earning assets	\$1,186,623	\$33,357	3.76	% \$1,170,491	\$33,301	3.80	%	
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$611,741	\$2,864	0.63	% \$598,427	\$2,501	0.56	%	
Savings deposits	141,430	159	0.15	% 140,709	186	0.18	%	
Time deposits	107,767	344	0.43	% 122,101	410	0.45	%	
Borrowings	5,385	104	2.58	% ---	---	---		
Total interest-bearing liabilities	\$866,323	\$3,471	0.54	% \$861,237	\$3,097	0.48	%	
Net interest income and interest rate spread		\$29,886	3.22	%	\$30,204	3.32	%	
Net yield on average interest-earning assets			3.37	%		3.45	%	

Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income (1)tax rate of 21% for the nine month period ended September 30, 2018 and 35% for the nine month period ended September 30, 2017.

(2) Included in interest income are loan fees of \$87 and \$248 for the nine months ended September 30, 2018 and 2017, 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 Company is invested in certain tax-advantaged loans and securities. To calculate the net interest margin, interest income on tax-advantaged investments is grossed up to a fully-taxable equivalent yield. The following tables reconcile net interest income on a GAAP basis to net interest income on a fully-taxable equivalent basis.

	Three Months Ended September 30,	
	2018	2017
Net interest income	\$9,700	\$9,280
Add: taxable equivalent adjustment	396	802
Net interest income, fully taxable equivalent basis	\$10,096	\$10,082

	Nine Months Ended September 30,	
	2018	2017
Net interest income	\$28,684	\$27,737
Add: taxable equivalent adjustment	1,202	2,467
Net interest income, fully taxable equivalent basis	\$29,886	\$30,204

The net interest margin decreased 6 basis points when the three month periods ended September 30, 2018 and September 30, 2017 are compared, and 8 basis points when the nine month periods ended September 30, 2018 and September 30, 2017 are compared. The decrease in interest rate spread resulted from a decline in the yield on earning assets of 4 basis points for the nine month period, and an increase in the cost of interest-bearing liabilities of 11 basis points for the three month period and 6 basis points for the nine month period when the periods ended September 30, 2018 and September 30, 2017 are compared.

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The yield on loans declined 1 basis point when the three month period ended September 30, 2018 is compared with the same period ended September 30, 2017, and 6 basis points when the nine month periods ended September 30, 2018 and September 30, 2017 are compared. The decline stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The decrease in the Company's tax rate from a marginal rate of 35% in 2017 to 21% in 2018 also reduced the fully taxable-equivalent yield on nontaxable loans when the three and nine month periods ended September 30, 2018 and 2017 are compared.

The yield on taxable securities increased 21 basis points when the three month period ended September 30, 2018 is compared with the same period ended September 30, 2017, and increased 17 basis point when the nine month periods ended September 30, 2018 and September 30, 2017 are compared. The yield on nontaxable securities decreased 121 basis points when the three month periods ended September 30, 2018 and September 30, 2017 are compared and declined 119 basis points when the nine month periods ended September 30, 2018 and September 30, 2017 are compared. As with nontaxable loans, the fully taxable-equivalent yield on nontaxable securities was negatively impacted by the reduction in tax rate.

The increase in the cost of interest-bearing liabilities came from an increase in the cost of interest-bearing demand deposits and the cost of short-term borrowing. The cost of interest-bearing demand deposits increased 10 basis points for the three month period ending September 30, 2018, when compared with the same period ended September 30, 2017 and increased 7 basis points when the nine month periods ended September 30, 2018 and September 30, 2017 are compared. During the third quarter of 2018, the Company accessed its borrowing capacity with the Federal Home Loan Bank. The short-term facilities provide liquidity. Management expects that maturities of securities and seasonal deposit increases will replace the borrowings in the near term. 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 calculation of the allowance for loan losses resulted in a provision for loan losses of \$223 for the three month period ended September 30, 2018, compared with a provision for loan losses of \$201, for the same period ended September 30, 2017. For the nine month period ended September 30, 2018, the Company calculated a provision of \$93, compared with a provision of \$724 for the nine month period ended September 30, 2017. 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 September 30, 2018 was 1.10%, which compares to 1.19% at December 31, 2017 and 1.28% at September 30, 2017. The net charge-off ratio was 0.06% for the nine months ended September 30, 2018, 0.11% for the nine months ended September 30, 2017 and 0.08% for the year ended December 31, 2017. See "Asset Quality" for additional information.

Noninterest Income

**Three Months
Ended**

	September 30, 2018	September 30, 2017	Percent Change
Service charges on deposits	\$673	\$ 710	(5.21)%
Other service charges and fees	20	42	(52.38)%
Credit and debit card fees	362	315	14.92 %
Trust fees	355	365	(2.74)%
BOLI income	222	233	(4.72)%
Other income	282	215	31.16 %
Realized securities gain, net	---	4	NR

	Nine Months Ended		Percent Change
	September 30, 2018	September 30, 2017	
Service charges on deposits	\$2,037	\$ 2,067	(1.45)%
Other service charges and fees	87	152	(42.76)%
Credit and debit card fees	1,071	854	25.41 %
Trust fees	1,131	1,127	0.35 %
BOLI income	678	522	29.89 %
Other income	801	735	8.98 %
Realized securities gain, net	---	8	NR

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Service charges on deposit accounts decreased slightly for the three and nine month periods ended September 30, 2018 when compared with the same periods ended September 30, 2017. Other service charges and fees decreased when the three and nine month periods ended September 30, 2018 are compared with the same periods ended September 30, 2017. 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 are presented net of interchange expense. Credit and debit card fees increased \$47 for the three months and \$217 for the nine months ended September 30, 2018, when compared with the same periods last year. During the latter half of 2017, the Company sold its merchant processing business, which resulted in a decline in associated merchant interchange expense when the three and nine month periods ended September 30, 2018 and September 30, 2017 are compared. Credit and debit card fees are based on volume and other factors.

Income from trust fees decreased \$10 for the three months and increased \$4 for the nine months ended September 30, 2018, compared with the same periods ended September 30, 2017. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income decreased \$11 for the three months and increased \$156 for the nine months ended September 30, 2018 compared with the same periods ended September 30, 2017. The Company purchased \$10 million in additional BOLI investments on June 30, 2017.

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 competitive factors. Other income increased \$67 for the three month and \$66 for the nine months ended September 30, 2018, when compared with the same periods ended September 30, 2017.

The Company did not realize any securities gains or losses during the three or nine month periods ended September 30, 2018. Realized net securities gains of \$4 were recorded during the third quarter of 2017 and \$8 were recorded for the nine months ended September 30, 2018. Net realized securities gains and losses are market driven and have resulted from calls of securities.

Noninterest Expense

	Three Months Ended September 30, 2018	September 30, 2017	Percent Change	
Salaries and employee benefits	\$3,639	\$ 3,478	4.63	%
Occupancy, furniture and fixtures	433	459	(5.66))%
Data processing and ATM	684	565	21.06	%
FDIC assessment	88	93	(5.38))%
Intangibles amortization	12	13	(7.69))%

Net costs of other real estate owned	274	58	372.41	%
Franchise taxes	314	332	(5.42)	%
Other operating expenses	1,019	1,033	(1.36)	%

	Nine Months Ended			
	September	September	Percent	
	30,	30, 2017	Change	
	2018			
Salaries and employee benefits	\$10,878	\$ 10,420	4.40	%
Occupancy, furniture and fixtures	1,396	1,366	2.20	%
Data processing and ATM	2,024	1,673	20.98	%
FDIC assessment	269	279	(3.58)	%
Intangibles amortization	37	56	(33.93)	%
Net costs of other real estate owned	523	142	268.31	%
Franchise taxes	965	983	(1.83)	%
Write-down of insurance receivable	2,010	---	NR	
Other operating expenses	2,949	3,369	(12.47)	%

Total noninterest expense increased \$432 or 7.16% for the three month period ended September 30, 2018 when compared with the same period of 2017. When the nine month periods ended September 30, 2018 and 2017 are compared, total noninterest expense increased \$2,763 or 15.11%. The increases in both the three and nine month periods were affected by increases in salaries and employee benefits, data processing and ATM, and write-down of an OREO property. The nine-month period was also affected by the write down of an insurance receivable, partially offset by a decline in other operating expenses.

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Salaries and employee benefits increased \$161 or 4.63% for the three month period ended September 30, 2018 when compared with the same period in 2017. When the nine month periods ended September 30, 2018 and 2017 are compared, salaries and employee benefits increased \$458 or 4.40%. This expense category includes employee salaries, payroll taxes, insurance and fringe benefits, ESOP contribution accruals, the service component of net periodic pension cost, and salary continuation expenses. When the nine month periods are compared, a decrease in salary expense of \$261 was offset by increases in payroll taxes of \$76, fringe benefits of \$211, ESOP of \$100, and pension servicing cost of \$158. Please refer to Note 1: General for information on adoption of pension accounting guidance effective January 1, 2018.

Occupancy, furniture and fixtures expense decreased \$26 or 5.66% when the three month periods ended September 30, 2018 and September 30, 2017 are compared. When the nine month periods ended September 30, 2018 and 2017 are compared, occupancy, furniture and fixtures expense increased \$30 or 2.20%. The increases are the result of normal business investments.

Data processing and ATM expense increased \$119 for the three month period and \$351 for the nine month period ended September 30, 2018, compared with the same periods in 2017, due to infrastructure upgrades.

FDIC assessment expense decreased \$5 for the three month period and \$10 for the nine month period ended September 30, 2018 when compared with the same periods of 2017. The FDIC assessment is accrued based on a method provided by the FDIC. The calculation is based on average assets divided by average tangible equity and incorporates risk-based factors to determine the amount of the assessment.

Core deposit intangibles are the result of prior merger and acquisition activity and are amortized over a period of years. Certain of the Company's intangible assets became fully amortized during 2017. This accounted for the decline in intangibles amortization expense of \$19 for the nine month period ended September 30, 2018, compared with the same period of 2017.

Net costs of other real estate owned increased \$216 for the three month period and \$381 for nine month period ended September 30, 2018, compared with the same periods in 2017. 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. Write downs on OREO properties were \$452 for the nine months ended September 30, 2018, compared with \$83 for the nine months ended September 30, 2017. The Company recognized a loss on the sale of OREO of \$12 for the nine months ended September 30, 2018, compared with a gain of \$4 for the nine months ended September 30, 2017.

Franchise tax expense for the three month and nine month periods ended September 30, 2018 were at a similar level to the same periods ended September 30, 2017. Franchise tax is based on capital levels of the subsidiary bank.

The Company recognized an expense of \$2,010 during the nine month period ended September 30, 2018. The expense reduced the insurance receivable related to a cybersecurity breach. The Company is pursuing legal action against the insurance carrier. Please see the discussion under the section "Cybersecurity Risks and Incidents" below.

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. Other operating expense decreased \$14 or 1.36% for the three month period and \$420 or 12.47% for the nine month period ended September 30, 2018, compared with the same periods of 2017. The decrease is related to consulting and advisory services for the

cybersecurity breach and non-service components of net periodic pension cost. During the nine months of 2017, the Company incurred \$363 in consulting and advisory and legal expenses related to the cybersecurity breach (discussed in further detail below). Consulting and advisory and legal expense for the first nine months of 2018 was \$65. Expense for non-service components of net periodic pension cost decreased \$305 when the nine month periods ended September 30, 2018 and September 30, 2017 are compared.

Cybersecurity Risks and Incidents

As disclosed in previous reports, the Company's computer system experienced two cyber intrusions, one in May of 2016 and one in January of 2017. The theft of funds totaled \$2,408. The Company notified all affected customers, restored all funds so that no customer experienced a loss, and filed a claim with its insurance carrier.

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 investigations.

The Company filed an insurance claim in 2017 for both of the breaches. During the first quarter of 2018, the Company received informal communication from the carrier and estimated that under a worst-case scenario, the carrier would reimburse \$337. Management wrote down the insurance receivable by \$1,723, with the expectation that litigation would ultimately result in recovery. During the second quarter of 2018, the insurance carrier responded with an offer of \$50, resulting in an additional write-down of \$287. The Company is vigorously pursuing litigation to recover the full amount of the breaches and legal costs. If the Company recovers amounts in excess of the receivable, it will recognize a gain in the period of recovery.

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The Company has a program to identify, mitigate and manage its cybersecurity risks. The program includes penetration testing and vulnerability assessment, technological defenses such as antivirus software, patch management, and firewall management, ongoing employee training, email and web protections, an intrusion prevention system and an additional targeted cybersecurity insurance policy. Cybersecurity costs other than the insurance receivable write-down include legal fees, system monitoring and protection and insurance and totaled \$247 for the nine months ended September 30, 2018. Cybersecurity costs for the nine months ended September 30, 2017 included breach investigation, system monitoring and protection and totaled \$472. These costs are included in various categories of noninterest expense.

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

Income Tax

The Tax Cuts and Jobs Act (“the Act”) was enacted December 22, 2017 and took effect January 1, 2018. The Act reduced the Company’s statutory tax rate from a marginal rate of 35% to a flat 21%. The Company’s effective tax rate for the three month period ended September 30, 2018 was 13.74%, compared with 23.26% for the three month period ended September 30, 2017. The Company’s effective tax rate for the nine month period ended September 30, 2018 was 13.17%, compared with 22.45% for the nine month period ended September 30, 2017.

Balance Sheet

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

Assets	September 30, 2018	December 31, 2017	Percent Change	
Interest-bearing deposits	\$39,366	\$71,603	(45.02)	%
Securities available for sale and restricted stock	388,653	310,499	25.17	%
Securities held to maturity	73,690	131,602	(44.01)	%
Loans, net	669,116	644,998	3.74	%
Total assets	1,254,684	1,235,755	1.53	%
Liabilities and stockholders’ equity				
Noninterest-bearing demand deposits	\$190,185	\$178,708	6.42	%

Interest-bearing demand deposits	611,741	598,661	2.18	%
Savings deposits	141,430	140,997	0.31	%
Time deposits	107,767	120,220	(10.36)	%
Stockholders' equity	186,078	184,540	0.83	%

Securities

During the second quarter of 2018, the Company reclassified all held to maturity securities as available for sale. At the time of transfer, the securities were recorded at fair value of \$119,790 and an unrealized gain of \$891, net of tax was recorded in accumulated other comprehensive income.

Management regularly monitors the quality of the securities portfolio and 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.

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	September 30, 2018	December 31, 2017	Percent Change	
Real estate construction loans	\$ 42,548	\$ 34,694	22.64	%
Consumer real estate loans	171,679	166,965	2.82	%
Commercial real estate loans	346,756	340,414	1.86	%
Commercial non real estate loans	44,497	40,518	9.82	%
Public sector and IDA	59,369	51,443	15.41	%
Consumer non real estate	37,587	34,648	8.48	%
Less: unearned income and deferred fees and costs	(602)	(613)	1.79	%
Loans, net of unearned income and deferred fees and costs	\$ 701,834	\$ 668,069	5.05	%

The Company's loans, net of unearned income and deferred fees and costs increased \$33,765 or 5.05% from \$668,069 at December 31, 2017 to \$701,834 at September 30, 2018. All loan categories increased from December 31, 2017 with the largest growth in real estate construction loans and public sector and IDA loans.

Deposits

	September 30, 2018	December 31, 2017	Percent Change	
Noninterest-bearing demand deposits	\$ 199,953	\$ 182,511	9.56	%
Interest-bearing demand deposits	584,305	622,189	(6.09))%
Saving deposits	141,751	140,150	1.14	%
Time deposits	96,167	114,884	(16.29))%
Total deposits	\$ 1,022,176	\$ 1,059,734	(3.54))%

Total deposits decreased \$37,558 or 3.54% from \$1,059,734 at December 31, 2017 to \$1,022,176 at September 30, 2018. Increases in noninterest-bearing demand and savings deposits totaled \$19,043 when September 30, 2018 is compared with December 31, 2017. These increases were offset by a decrease in interest-bearing demand and time deposits of \$56,601 when September 30, 2018 is compared with December 31, 2017. Continued 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 liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At September 30, 2018, the bank had \$35,000 in short-term FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

The Company considers its security portfolio for typical liquidity needs, within accounting, legal and strategic parameters. Prior to the second quarter of 2018, the securities portfolio was segregated into available-for-sale and held-to-maturity. During the second quarter of 2018, the Company re-classified all its held-to-maturity securities to available-for-sale. Portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased/decreased liquidity from public funds deposits or discount window borrowings results in increased/decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and unpledged available-for-sale securities accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to use purchased deposits and the Federal Reserve discount window. At September 30, 2018, the Company is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At September 30, 2018, the Company's liquidity is sufficient to meet projected trends in these areas.

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To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At September 30, 2018, 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 September 30, 2018, the loan to deposit ratio was 68.66%. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

Capital Resources

Total stockholders' equity at September 30, 2018 was \$188,157, an increase of \$3,261 or 1.76%, from the \$184,896 at December 31, 2017.

Risk based capital ratios at September 30, 2018 are shown in the following table.

	Consolidated	NBB	Regulatory Capital Minimum Ratios	Regulatory Capital Minimum Ratios with Capital Conservation Buffer		
Common Equity Tier I Capital Ratio	23.66	% 23.38 %	4.50	% 6.375	%	
Tier I Capital Ratio	23.66	% 23.38 %	6.00	% 7.875	%	
Total Capital Ratio	24.59	% 24.31 %	8.00	% 9.875	%	
Leverage Ratio	15.82	% 15.53 %	4.00	% NA		

Risk-based capital ratios are calculated in compliance with Federal Reserve rules based on Basel III capital requirements. The Company's and Bank's ratios are well above the required minimums at September 30, 2018.

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

The Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (EGRRCPA), enacted in May 2018, contains provisions that will affect regulations applicable to the Company and the Bank. In compliance with EGRRCPA, the Federal Reserve Board issued in August 2018 an interim final rule expanding the applicability of the small bank holding company policy statement to bank holding companies with consolidated total assets of less than \$3 billion. The small bank holding company policy statement, among other things, exempts bank holding companies below the threshold from reporting consolidated regulatory capital ratios and from minimum regulatory capital requirements that apply to bank holding companies that exceed the threshold. The statement previously applied only to bank holding companies with consolidated total assets of less than \$1 billion. As a result of the interim final rule, the Company expects that it will be treated as a small bank holding company and will no longer be subject to regulatory capital requirements.

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. Our agreement with the purchaser provides for strict underwriting and documentation requirements. Violation of the representations and warranties of the agreement would entitle the purchaser to recourse provisions. 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 September 30, 2018. 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 nine months ended September 30, 2018, except for normal seasonal fluctuations in the total of mortgage loan commitments.

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Contractual Obligations

The Company had no capital lease or purchase obligations and no long-term debt at September 30, 2018. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material as of September 30, 2018 and have not changed materially from those which were disclosed in the Company's 2017 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, 2017 in the Company's 2017 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 September 30, 2018 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended September 30, 2018 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 2017 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.

Table of Contents**Item 5. Other Information**

None.

Item 6. Exhibits**Index of Exhibits**

Exhibit No.	Description	Page No. in Sequential System
3(i)	<u>Amended and Restated Articles of Incorporation of National Bankshares, Inc.</u>	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	<u>Amended By-laws of National Bankshares, Inc.</u>	(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)	<u>National Bankshares, Inc. 1999 Stock Option Plan</u>	(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)	<u>Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015)
*10(iii)	<u>Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg</u>	(incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002)
*10(iv)	<u>Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo</u>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015)
*10(v)	<u>Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes</u>	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vi)	<u>Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo</u>	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vii)	<u>Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens</u>	(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 September 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)

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Exhibit No.	Description	Page No. in Sequential System
*10(xv)	<u>Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens</u>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xvi)	<u>Salary Continuation Agreement dated May 24, 2013 between The National Bank of Blacksburg and Paul A. Mylum</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 8, 2018)
*10(xvii)	<u>Second Salary Continuation Agreement dated July 1, 2016 between The National Bank of Blacksburg and F. Brad Denardo</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on July 20, 2016)
*10(xviii)	<u>Salary Continuation Agreement dated February 6, 2006 between The National Bankshares, Inc. and Lara E. Ramsey</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xix)	<u>First Amendment, dated December 19, 2007, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xx)	<u>Second Amendment, dated September 12, 2008, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xxi)	<u>Third Amendment, dated September 22, 2016, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</u>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
+23	<u>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</u>	(incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2017)
+31(i)	<u>Section 906 Certification of Chief Executive Officer</u>	(included herewith)
+31(ii)	<u>Section 906 Certification of Chief Financial Officer</u>	(included herewith)
+32(i)	<u>18 U.S.C. Section 1350 Certification of Chief Executive Officer</u>	(included herewith)

- +32(ii) 18 U.S.C. Section 1350 Certification of Chief Financial Officer (included herewith)
The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended September 30, 2018 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Statements of Income for the three and nine month periods ended September 30, 2018 and 2017;
- +101 (ii) Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2018 and 2017; (iii) Consolidated Balance Sheets at September 30, 2018 and December 31, 2017; (iv) Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2018 and 2017; (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017; and (vi) Notes to Consolidated Financial Statements. (included herewith)

* Indicates a management contract or compensatory plan.

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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: November 7, 2018 /s/ F. Brad Denardo
F. Brad Denardo
President and

Chief Executive Officer

(Principal Executive Officer)

Date: November 7, 2018 /s/ David K. Skeens
David K. Skeens
Treasurer and

Chief Financial Officer

(Principal Financial Officer)

(Principal Accounting Officer)