

AMERICAN NATIONAL BANKSHARES INC.

Form 10-K

March 16, 2017

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2016

Commission file number 0-12820

AMERICAN NATIONAL BANKSHARES INC.

(Exact name of registrant as specified in its charter)

Virginia 54-1284688

(State of incorporation) (I.R.S. Employer Identification No.)

628 Main Street, Danville, VA 24541

(Address of principal executive offices) (Zip Code)

434-792-5111

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
---------------------	--------------------------------------

Common Stock, \$1 par value	NASDAQ Global Select Market
-----------------------------	-----------------------------

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes No

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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

The aggregate market value of the voting stock held by non-affiliates of the registrant at June 30, 2016, based on the closing price, was \$199,946,222.

The number of shares of the registrant's common stock outstanding on March 9, 2017 was 8,638,744.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on May 16, 2017, are incorporated by reference in Part III of this report.

CROSS REFERENCE INDEX

	PAGE
PART I	
ITEM 1 <u>Business</u>	<u>3</u>
ITEM 1A <u>Risk Factors</u>	<u>14</u>
ITEM 1B Unresolved Staff Comments	None
ITEM 2 <u>Properties</u>	<u>22</u>
ITEM 3 <u>Legal Proceedings</u>	<u>22</u>
ITEM 4 <u>Mine Safety Disclosures</u>	<u>22</u>
PART II	
ITEM 5 <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>23</u>
ITEM 6 <u>Selected Financial Data</u>	<u>26</u>
ITEM 7 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>27</u>
ITEM 7A <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>53</u>
ITEM 8 <u>Financial Statements and Supplementary Data</u>	<u>54</u>
<u>Reports of Independent Registered Public Accounting Firm</u>	<u>55</u>
<u>Consolidated Balance Sheets at December 31, 2016 and 2015</u>	<u>58</u>
<u>Consolidated Statements of Income for the years ended December 31, 2016, 2015, and 2014</u>	<u>59</u>
<u>Consolidated Statements of Comprehensive Income for the years ended December 31, 2016, 2015, and 2014</u>	<u>60</u>
<u>Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2016, 2015, and 2014</u>	<u>61</u>
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2016, 2015, and 2014</u>	<u>62</u>
<u>Notes to Consolidated Financial Statements</u>	<u>63</u>
ITEM 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	None
ITEM 9A <u>Controls and Procedures</u>	<u>108</u>
<u>Management's Report on Internal Control over Financial Reporting</u>	<u>108</u>
ITEM 9B Other Information	None
PART III	
ITEM 10 Directors, Executive Officers and Corporate Governance	*
ITEM 11 Executive Compensation	*
ITEM 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	*
ITEM 13 Certain Relationships and Related Transactions, and Director Independence	*
ITEM 14 Principal Accountant Fees and Services	*
PART IV	
ITEM 15 <u>Exhibits and Financial Statement Schedules</u>	<u>109</u>
ITEM 16 <u>Form 10-K Summary</u>	<u>111</u>

*Certain information required by Item 10 is incorporated herein by reference to the information that appears under the headings "Election of Directors," "Election of Directors – Board Members Serving on Other Publicly Traded Company"

Boards of Directors," "Election of Directors – Board of Directors and Committees - The Audit Committee," "Section 16(a) Beneficial Ownership Reporting Compliance," "Report of the Audit Committee," and "Code of Conduct" in the Registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders. The information required by Item 401 of Regulation S-K on executive officers is disclosed herein.

The information required by Item 11 is incorporated herein by reference to the information that appears under the headings "Compensation Discussion and Analysis," "Compensation Committee Interlocks and Insider Participation," and "Compensation Committee Report" in the Registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders.

The information required by Item 12 is incorporated herein by reference to the information that appears under the heading "Security Ownership" in the Registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

The information required by Item 13 is incorporated herein by reference to the information that appears under the headings "Related Party Transactions" and "Election of Directors – Board Independence" in the Registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders.

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading "Independent Registered Public Accounting Firm" in the Registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders.

PART I

Forward-Looking Statements

This report contains forward-looking statements with respect to the financial condition, results of operations and business of American National Bankshares Inc. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Forward-looking statements are subject to numerous assumptions, estimates, risks, and uncertainties that could cause actual conditions, events, or results to differ materially from those stated or implied by such forward-looking statements.

A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors, may affect the operations, performance, business strategy, and results of the Company. Those factors include but are not limited to the following:

• Financial market volatility including the level of interest rates could affect the values of financial instruments and the amount of net interest income earned;

• General economic or business conditions, either nationally or in the market areas in which the Company does business, may be less favorable than expected, resulting in deteriorating credit quality, reduced demand for credit, or a weakened ability to generate deposits;

• Competition among financial institutions may increase and competitors may have greater financial resources and develop products and technology that enable those competitors to compete more successfully than the Company;

• Businesses that the Company is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards;

• The ability to retain key personnel;

• The failure of assumptions underlying the allowance for loan losses; and

• Risks associated with mergers, acquisitions, and other expansion activities.

ITEM 1 – BUSINESS

American National Bankshares Inc. is a one-bank holding company organized under the laws of the Commonwealth of Virginia in 1984. On September 1, 1984, the Company acquired all of the outstanding capital stock of American National Bank and Trust Company, a national banking association chartered in 1909 under the laws of the United States. American National Bank and Trust Company is the only banking subsidiary of the Company.

On July 1, 2011, the Company completed its acquisition of MidCarolina Financial Corporation ("MidCarolina") pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated December 15, 2010, between the Company and MidCarolina. MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank. The transaction has expanded the Company's footprint in North Carolina, adding eight branches in Alamance and Guilford Counties.

On January 1, 2015, the Company completed its acquisition of MainStreet BankShares, Inc. ("MainStreet") pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between the Company and MainStreet. Immediately after the merger of MainStreet into the Company, Franklin Community Bank, N.A. ("Franklin Bank"), MainStreet's wholly-owned bank subsidiary, merged with and into the Bank. Franklin Bank provided banking services to its customers from three banking offices located in Rocky Mount, Hardy, and Union Hall, Virginia.

As of December 31, 2016, the operations of the Company are conducted at twenty-six banking offices and two loan production offices in Roanoke, Virginia and Raleigh, North Carolina. The Bank provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through thirty-four Automated Teller Machines ("ATMs"), "Online Banking," and "Telephone Banking."

The Company has two reportable segments, (i) community banking and (ii) trust and investment services. For more financial data and other information about each of the Company's operating segments, refer to "Note 21 - Segment and Related Information" of the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

Competition and Markets

Vigorous competition exists in the Company's service areas. The Company competes not only with national, regional, and community banks, but also with other types of financial institutions including savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies.

3

The Company has the largest deposit market share in the City of Danville, Virginia. The Company had a deposit market share in the Danville Micropolitan Statistical Area of 31.1% at June 30, 2016, based on Federal Deposit Insurance Corporation ("FDIC") data. The Company has the second largest deposit market share in Pittsylvania County, Virginia. The Company had a deposit market share in Pittsylvania County of 22.9% at June 30, 2016, based on FDIC data.

The Southern Virginia market, in which the Company has a significant presence, continues to show improvement. The region's economic base continues to be weighted toward the manufacturing sector. Although the region was negatively impacted by the elimination of many textile plant closings over several decades, the area has experienced some new manufacturing plant openings as well as job growth in the technology area. Other important industries include farming, tobacco processing and sales, food processing, and packaging tape production.

The Company's market areas in North Carolina are Alamance County and Guilford County, North Carolina, where there is strong competition in attracting deposits and making loans. Its most direct competition for deposits comes from commercial banks, savings institutions and credit unions located in the market area, including large financial institutions that have greater financial and marketing resources available to them. The Company had a deposit market share in Alamance County of 14.7% at June 30, 2016, based on FDIC data, which was the second largest of any FDIC-insured institution.

In 2016, the Company announced plans for a de novo branch in Roanoke, Virginia, and Winston-Salem, North Carolina.

Supervision and Regulation

The Company and the Bank are extensively regulated under federal and state law. The following information describes certain aspects of that regulation applicable to the Company and the Bank and does not purport to be complete. Proposals to change the laws and regulations governing the banking industry are frequently raised in U.S. Congress, in state legislatures, and before the various bank regulatory agencies. The likelihood and timing of any changes and the impact such changes might have on the Company and the Bank are impossible to determine with any certainty. A change in applicable laws or regulations, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material impact on the business, operations, and earnings of the Company and the Bank.

American National Bankshares Inc.

American National Bankshares Inc. is qualified as a bank holding company ("BHC") within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). As a bank holding company, American National Bankshares Inc. is subject to supervision, regulation and examination by the FRB and is required to file various reports and additional information with the FRB. American National Bankshares Inc. is also registered under the bank holding company laws of Virginia and is subject to supervision, regulation and examination by the Bureau of Financial Institutions of the Virginia State Corporation Commission (the "SCC").

Under the Gramm-Leach-Bliley Act, a BHC may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional BHC's. In order to qualify for the election, all of the depository institution subsidiaries of the BHC must be well capitalized, well managed, and have achieved a rating of "satisfactory" or better under the Community Reinvestment Act (the "CRA"). Financial holding companies are permitted to engage in activities that are "financial in nature" or incidental or complementary thereto as determined by the FRB. The Gramm-Leach-Bliley Act identifies several activities as "financial in nature," including insurance underwriting and sales, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. American National Bankshares Inc. has not elected to become a financial holding company, and has no plans to become a financial holding company.

American National Bank and Trust Company

American National Bank and Trust Company is a federally chartered national bank and is a member of the Federal Reserve System. It is subject to federal regulation by the Office of the Comptroller of the Currency (the "OCC"), the FRB, and the FDIC.

Depository institutions, including the Bank, are subject to extensive federal and state regulations that significantly affect their business and activities. Regulatory bodies have broad authority to implement standards and initiate

proceedings designed to prohibit depository institutions from engaging in unsafe and unsound banking practices. The standards relate generally to operations and management, asset quality, interest rate exposure, and capital. The bank regulatory agencies are authorized to take action against institutions that fail to meet such standards.

As with other financial institutions, the earnings of the Bank are affected by general economic conditions and by the monetary policies of the FRB. The FRB exerts a substantial influence on interest rates and credit conditions, primarily through open market operations in U.S. Government securities, setting the reserve requirements of member banks, and establishing the discount rate on member bank borrowings. The policies of the FRB have a direct impact on loan and deposit growth and the interest rates charged and paid thereon. They also impact the source, cost of funds, and the rates of return on investments. Changes in the FRB's monetary policies have had a significant impact on the operating results of the Bank and other financial institutions and are expected to continue to do so in the future; however, the exact impact of such conditions and policies upon the future business and earnings cannot accurately be predicted.

The Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act significantly restructured the financial regulatory regime in the United States and has had a broad impact on the financial services industry as a result of the significant regulatory and compliance changes required under the act. A summary of certain provisions of the Dodd-Frank Act is set forth below:

Increased Capital Standards. The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. See "Capital Requirements" below. Among other things, the Dodd-Frank Act provides for newer and stronger standards.

Deposit Insurance. The Dodd-Frank Act makes permanent the \$250,000 deposit insurance limit for insured deposits. Amendments to the Federal Deposit Insurance Act also revise the assessment base against which an insured depository institution's deposit insurance premiums paid to the Deposit Insurance Fund (the "DIF") will be calculated. Under the amendments, the assessment base will no longer be the institution's deposit base, but rather its average consolidated total assets less its average tangible equity during the assessment period. Additionally, the Dodd-Frank Act makes changes to the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act also provides that depository institutions may pay interest on demand deposits.

The Consumer Financial Protection Bureau ("CFPB"). The CFPB is charged with establishing rules and regulations under certain federal consumer protection laws with respect to the conduct of providers of certain consumer financial products and services.

Compensation Practices. The Dodd-Frank Act provides that the appropriate federal regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company or bank that provides an insider or other employee with "excessive compensation" or could lead to a material financial loss to such firm. In June 2010, prior to the Dodd-Frank Act, the federal bank regulatory agencies promulgated the Interagency Guidance on Sound Incentive Compensation Policies, which requires that financial institutions establish metrics for measuring the impact of activities to achieve incentive compensation with the related risk to the financial institution of such behavior.

Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, certain of the act's requirements have yet to be implemented. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the federal bank regulatory agencies in the future, the full extent of the impact such requirements will have on the operations of the Company and the Bank is unclear. The future changes resulting from the Dodd-Frank Act may affect the profitability of business activities, require changes to certain business practices, impose more stringent regulatory requirements or otherwise adversely affect the business and financial condition of the Company and the Bank. These changes may also require the Company to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and regulatory requirements.

Deposit Insurance

The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the FDIC and are subject to deposit insurance assessments to maintain the DIF. On April 1, 2011, the deposit insurance assessment base changed from total deposits to average total assets minus average tangible equity, pursuant to a rule issued by the FDIC as required by the Dodd-Frank Act. Also on April 1, 2011, the FDIC began utilizing a risk-based assessment system that imposed insurance premiums based upon a risk category matrix that took into account a bank's capital level and supervisory rating. Effective July 1, 2016, the FDIC again changed its deposit insurance pricing and eliminated all risk categories and now uses the "financial ratios method" based on CAMELS composite ratings to determine assessment rates for small established institutions with less than \$10 billion in assets. The CAMELS rating system is a supervisory rating system designed to take into account and reflect all financial and operational risks that a bank may face, including capital adequacy, asset quality, management capability, earnings, liquidity and sensitivity to market risk ("CAMELS"). CAMELS composite ratings set a maximum assessment for CAMELS 1 and 2 rated banks, and set minimum assessments for lower rated institutions.

The FDIC's "reserve ratio" of the DIF to total industry deposits reached its 1.15% target effective June 30, 2016. On March 15, 2016, the FDIC implemented by final rule certain Dodd-Frank Act provisions by raising the DIF's minimum reserve ratio from 1.15% to 1.35%. The FDIC imposed a 4.5 basis point annual surcharge on insured depository institutions with total consolidated assets of \$10 billion or more. The new rule grants credits to smaller banks for the portion of their regular assessments that contribute to increasing the reserve ratio from 1.15% to 1.35%. Prior to when the new assessment system became effective, the Bank's overall rate for assessment calculations was 9 basis points or less, which was within the range of assessment rates for the lowest risk category under the former FDIC assessment rules. In 2016 and 2015, the Company recorded expense of \$647,000 and \$750,000, respectively, for FDIC insurance premiums.

In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately one basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2019.

Capital Requirements

The FRB, the OCC and the FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to all banks and bank holding companies. In addition, those regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its financial condition or actual or anticipated growth. Under the risk-based capital requirements of these federal bank regulatory agencies that were effective through December 31, 2016, American National Bankshares Inc. and American National Bank were required to maintain a minimum ratio of total capital (which is defined as core capital and supplementary capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments) to risk-weighted assets of at least 8.0%. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet activities, recourse obligations, residual interests and direct credit substitutes, were multiplied by a risk-weight factor assigned by the capital regulation based on the risks believed inherent in the type of asset.

On June 7, 2012, the FRB issued a series of proposed rules intended to revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Effective January 1, 2015, the final rules required the Company and the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets (increased from the prior requirement of 4%); (iii) a total capital ratio of 8% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4% of total assets (unchanged from the prior requirement). These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital

conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is

phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The Tier 1 and total capital to risk-weighted asset ratios of the Company were 13.83% and 14.81%, respectively, as of December 31, 2016, thus exceeding the minimum requirements. The common equity Tier 1 capital ratio of the Company was 11.77% and the Bank was 12.92% as of December 31, 2016. The Tier 1 and total capital to risk-weighted asset ratios of the Bank were 12.92% and 13.89%, respectively, as of December 31, 2016 also exceeding the minimum requirements.

The phase in of the capital conservation buffer requirement began on January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

With respect to the Bank, the rules also revised the "prompt corrective action" regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the prior ratio of 6.0%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized. These new thresholds were effective for the Bank as of January 1, 2015. The minimum total capital to risk-weighted assets ratio (10.0%) and minimum leverage ratio (5.0%) for well-capitalized status were unchanged by the final rules.

The new capital requirements also included changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancelable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

Based on management's understanding and interpretation of the new capital rules, it believes that, as of December 31, 2016, the Company and the Bank meet all capital adequacy requirements under such rules on a fully phased-in basis as if such requirements were in effect as of such date.

Dividends

The Company's principal source of cash flow, including cash flow to pay dividends to its shareholders, is dividends it receives from the Bank. Statutory and regulatory limitations apply to the Bank's payment of dividends to the Company. As a general rule, the amount of a dividend may not exceed, without prior regulatory approval, the sum of net income in the calendar year to date and the retained net earnings of the immediately preceding two calendar years. A depository institution may not pay any dividend if payment would cause the institution to become "undercapitalized" or if it already is "undercapitalized." The OCC may prevent the payment of a dividend if it determines that the payment would be an unsafe and unsound banking practice. The OCC also has advised that a national bank should generally pay dividends only out of current operating earnings.

Permitted Activities

As a bank holding company, American National Bankshares Inc. is limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the FRB determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the FRB must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the FRB may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the FRB has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding

company may result from such an activity.

7

Banking Acquisitions; Changes in Control

The BHC Act requires, among other things, the prior approval of the FRB in any case where a bank holding company proposes to (i) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless it already owns a majority of such voting shares), (ii) acquire all or substantially all of the assets of another bank or bank holding company, or (iii) merge or consolidate with any other bank holding company. In determining whether to approve a proposed bank acquisition, the FRB will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's performance under the Community Reinvestment Act of 1977 (the "CRA") and its compliance with fair housing and other consumer protection laws.

Subject to certain exceptions, the BHC Act and the Change in Bank Control Act, together with the applicable regulations, require FRB approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company acquiring "control" of a bank or bank holding company. A conclusive presumption of control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered its securities with the Securities and Exchange Commission under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or no other person will own a greater percentage of that class of voting securities immediately after the acquisition. The Company's common stock is registered under Section 12 of the Exchange Act.

In addition, Virginia law requires the prior approval of the SCC for (i) the acquisition of more than 5% of the voting shares of a Virginia bank or any holding company that controls a Virginia bank, or (ii) the acquisition by a Virginia bank holding company of a bank or its holding company domiciled outside Virginia.

Source of Strength

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

Safety and Soundness

There are a number of obligations and restrictions imposed on bank holding companies and their subsidiary banks by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance fund in the event of a depository institution default. For example, under the Federal Deposit Insurance Corporation Improvement Act of 1991, to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any subsidiary bank that may become "undercapitalized" with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal bank regulatory agency up to the lesser of (i) an amount equal to 5% of the institution's total assets at the time the institution became undercapitalized or (ii) the amount that is necessary (or would have been necessary) to bring the institution into compliance with all applicable capital standards as of the time the institution fails to comply with such capital restoration plan.

Under the FDIA, the federal bank regulatory agencies have adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines.

The Federal Deposit Insurance Corporation Improvement Act

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the federal bank regulatory agencies possess broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," as defined by the law.

Reflecting changes under the new Basel III capital requirements, the relevant capital measures that became effective on January 1, 2015 for prompt corrective action are the total capital ratio, the common equity Tier 1 capital ratio, the Tier 1 capital ratio and the leverage ratio. A bank will be (i) "well capitalized" if the institution has a total risk-based capital ratio of 10.0% or greater, a common equity Tier 1 capital ratio of 6.5% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any capital directive order; (ii) "adequately capitalized" if the institution has a total risk-based capital ratio of 8.0% or greater, a common equity Tier 1 capital ratio of 4.5% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 4.0% or greater and is not "well capitalized"; (iii) "undercapitalized" if the institution has a total risk-based capital ratio that is less than 8.0%, a common equity Tier 1 capital ratio less than 4.5%, a Tier 1 risk-based capital ratio of less than 6.0% or a leverage ratio of less than 4.0%; (iv) "significantly undercapitalized" if the institution has a total risk-based capital ratio of less than 6.0%, a common equity Tier 1 capital ratio less than 3.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 3.0%; and (v) "critically undercapitalized" if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank's capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes. Management believes, as of December 31, 2016 and 2015, the Company met the requirements for being classified as "well capitalized."

As required by FDICIA, the federal bank regulatory agencies also have adopted guidelines prescribing safety and soundness standards relating to, among other things, internal controls and information systems, internal audit systems, loan documentation, credit underwriting, and interest rate exposure. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the agencies adopted regulations that authorize, but do not require, an institution which has been notified that it is not in compliance with safety and soundness standard to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the prompt corrective action provisions described above.

Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended (the "Interstate Banking Act"), generally permits well capitalized bank holding companies to acquire banks in any state, and preempts all state laws restricting the ownership by a bank holding company of banks in more than one state. The Interstate Banking Act also permits a bank to merge with an out-of-state bank and convert any offices into branches of the resulting bank if both states have not opted out of interstate branching; and permits a bank to acquire branches from an out-of-state bank if the law of the state where the branches are located permits the interstate branch acquisition. Under the Dodd-Frank Act, a bank holding company or bank must be well capitalized and well managed to engage in an interstate acquisition. Bank holding companies and banks are required to obtain prior FRB approval to acquire more than 5% of a class of voting securities, or substantially all of the assets, of a bank holding company, bank or savings association. The Interstate Banking Act and the Dodd-Frank Act permit banks to establish and operate de novo interstate branches to the same extent a bank chartered by the host state may establish branches.

Transactions with Affiliates

Pursuant to Sections 23A and 23B of the Federal Reserve Act and Regulation W, the authority of the Bank to engage in transactions with related parties or "affiliates" or to make loans to insiders is limited. Loan transactions with an affiliate generally must be collateralized and certain transactions between the Bank and its affiliates, including the sale of assets, the payment of money or the provision of services, must be on terms and conditions that are substantially the same, or at least as favorable to the Bank, as those prevailing for comparable nonaffiliated transactions. In addition, the Bank generally may not purchase securities issued or underwritten by affiliates.

Loans to executive officers, directors or to any person who directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote more than 10% of any class of voting securities of a bank (a "10% Shareholders"), are subject to Sections 22(g) and 22(h) of the Federal Reserve Act and their

corresponding regulations (Regulation O) and Section 13(k) of the Exchange Act relating to the prohibition on personal loans to executives (which exempts financial institutions in compliance with the insider lending restrictions of Section 22(h) of the Federal Reserve Act). Among other things, these loans must be made on terms substantially the same as those prevailing on transactions made to unaffiliated individuals and certain extensions of credit to those persons must first be approved in advance by a disinterested majority of the entire board of directors. Section 22(h) of the Federal Reserve Act prohibits loans to any of those individuals where the aggregate amount exceeds an amount equal to 15% of an institution's unimpaired capital and surplus plus an

additional 10% of unimpaired capital and surplus in the case of loans that are fully secured by readily marketable collateral, or when the aggregate amount on all of the extensions of credit outstanding to all of these persons would exceed the Bank's unimpaired capital and unimpaired surplus. Section 22(g) of the Federal Reserve Act identifies limited circumstances in which the Bank is permitted to extend credit to executive officers.

Consumer Financial Protection

The Company is subject to a number of federal and state consumer protection laws that extensively govern its relationship with its customers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act, laws governing flood insurance, federal and state laws prohibiting unfair and deceptive business practices, foreclosure laws, and various regulations that implement some or all of the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans and providing other services. If the Company fails to comply with these laws and regulations, it may be subject to various penalties. Failure to comply with consumer protection requirements may also result in failure to obtain any required bank regulatory approval for merger or acquisition transactions the Company may wish to pursue or being prohibited from engaging in such transactions even if approval is not required.

The Dodd-Frank Act centralized responsibility for consumer financial protection by creating a new agency, the CFPB, and giving it responsibility for implementing, examining, and enforcing compliance with federal consumer protection laws. The CFPB focuses on (i) risks to consumers and compliance with the federal consumer financial laws, (ii) the markets in which firms operate and risks to consumers posed by activities in those markets, (iii) depository institutions that offer a wide variety of consumer financial products and services, and (iv) non-depository companies that offer one or more consumer financial products or services. The CFPB has broad rule making authority for a wide range of consumer financial laws that apply to all banks, including, among other things, the authority to prohibit "unfair, deceptive or abusive" acts and practices. Abusive acts or practices are defined as those that materially interfere with a consumer's ability to understand a term or condition of a consumer financial product or service or take unreasonable advantage of a consumer's (i) lack of financial savvy, (ii) inability to protect himself in the selection or use of consumer financial products or services, or (iii) reasonable reliance on a covered entity to act in the consumer's interests. The CFPB can issue cease-and-desist orders against banks and other entities that violate consumer financial laws. The CFPB may also institute a civil action against an entity in violation of federal consumer financial law in order to impose a civil penalty or injunction.

Community Reinvestment Act

The CRA requires the appropriate federal banking agency, in connection with its examination of a bank, to assess the bank's record in meeting the credit needs of the communities served by the bank, including low and moderate income neighborhoods. Furthermore, such assessment is also required of banks that have applied, among other things, to merge or consolidate with or acquire the assets or assume the liabilities of an insured depository institution, or to open or relocate a branch. In the case of a BHC applying for approval to acquire a bank or BHC, the record of each subsidiary bank of the applicant BHC is subject to assessment in considering the application. Under the CRA, institutions are assigned a rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance." The Company was rated "satisfactory" in its most recent CRA evaluation.

Anti-Money Laundering Legislation

The Company is subject to the Bank Secrecy Act and other anti-money laundering laws and regulations, including the USA Patriot Act of 2001. Among other things, these laws and regulations require the Company to take steps to prevent the use of the Company for facilitating the flow of illegal or illicit money, to report large currency transactions, and to file suspicious activity reports. The Company is also required to carry out a comprehensive anti-money laundering compliance program. Violations can result in substantial civil and criminal sanctions. In addition, provisions of the USA Patriot Act require the federal bank regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and BHC acquisitions.

Privacy Legislation

Several recent laws, including the Right to Financial Privacy Act, and related regulations issued by the federal bank regulatory agencies, also provide new protections against the transfer and use of customer information by financial institutions. A financial institution must provide to its customers information regarding its policies and procedures with respect to the handling of customers' personal information. Each institution must conduct an internal risk assessment of its ability to protect customer information. These privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated parties without prior notice and approval from the customer.

Incentive Compensation

In June 2010, the federal bank regulatory agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of financial institutions do not undermine the safety and soundness of such institutions by encouraging excessive risk-taking. The Interagency Guidance on Sound Incentive Compensation Policies, which covers all employees that have the ability to materially affect the risk profile of a financial institutions, either individually or as part of a group, is based upon the key principles that a financial institution's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the institution's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the financial institution's board of directors.

Section 956 of the Dodd-Frank Act requires the federal banking agencies and the Securities and Exchange Commission to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities that encourage inappropriate risk-taking by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. The federal banking agencies issued such proposed rules in March 2011 and issued a revised proposed rule in June 2016 implementing the requirements and prohibitions set forth in Section 956. The revised proposed rule would apply to all banks, among other institutions, with at least \$1 billion in average total consolidated assets, for which it would go beyond the existing Interagency Guidance on Sound Incentive Compensation Policies to (i) prohibit certain types and features of incentive-based compensation arrangements for senior executive officers, (ii) require incentive-based compensation arrangements to adhere to certain basic principles to avoid a presumption of encouraging inappropriate risk, (iii) require appropriate board or committee oversight and (iv) establish minimum recordkeeping and (v) mandate disclosures to the appropriate federal banking agency.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each financial institution based on the scope and complexity of the institution's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the institution's supervisory ratings, which can affect the institution's ability to make acquisitions and take other actions. Enforcement actions may be taken against a financial institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the institution's safety and soundness and the financial institution is not taking prompt and effective measures to correct the deficiencies. At December 31, 2016, the Company had not been made aware of any instances of non-compliance with the final guidance.

Volcker Rule

The Volcker Rule under the Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and investing in and sponsoring hedge funds and private equity funds. The Volcker Rule, which became effective in July 2015, does not significantly impact the operations of the Company or the Bank, as they do not have any significant engagement in the businesses prohibited by the Volcker Rule.

Ability-to-Repay and Qualified Mortgage Rule

Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance. The Company is predominantly an originator of compliant qualified mortgages.

Cybersecurity

In March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. If the Company fails to observe the regulatory guidance, it could be subject to various regulatory sanctions, including financial penalties.

Effect of Governmental Monetary Policies

The Company's operations are affected not only by general economic conditions, but also by the policies of various regulatory authorities. In particular, the FRB regulates money and credit conditions and interest rates to influence general economic conditions. These policies have a significant impact on overall growth and distribution of loans, investments and deposits; they affect interest rates charged on loans or paid for time and savings deposits. FRB monetary policies have had a significant effect on the operating results of commercial banks, including the Company, in the past and are expected to do so in the future. As a result, it is difficult for the Company to predict the potential effects of possible changes in monetary policies upon its future operating results.

Future Legislation and Regulation

Congress may enact legislation from time to time that affects the regulation of the financial services industry, and state legislatures may enact legislation from time to time affecting the regulation of financial institutions chartered by or operating in those states. Federal and state regulatory agencies also periodically propose and adopt changes to their regulations or change the manner in which existing regulations are applied. The substance or impact of pending or future legislation or regulation, or the application thereof, cannot be predicted, although enactment of the proposed legislation could impact the regulatory structure under which the Company and the Bank operate and may significantly increase costs, impede the efficiency of internal business processes, require an increase in regulatory capital, require modifications to business strategy, and limit the ability to pursue business opportunities in an efficient manner. A change in statutes, regulations or regulatory policies applicable to the Company or the Bank could have a material adverse effect on the business, financial condition and results of operations of the Company and the Bank. At this time, it is difficult to predict the legislative and regulatory changes that will result from the combination of a new President of the United States and the first year since 2010 in which both Houses of Congress and the White House have majority memberships from the same political party. In recent years, however, both the new President and

senior members of the House of Representatives have advocated for significant reduction of financial services regulation, to include amendments to the Dodd-Frank Act and structural changes to the CFPB. The new administration and Congress also may cause broader economic changes due to changes in governing ideology and governing style. Future legislation, regulation, and government

policy could affect the banking industry as a whole, including the business and results of operations of the Company and the Bank, in ways that are difficult to predict.

Employees

At December 31, 2016, the Company employed 320 full-time equivalent persons. In the opinion of the management of the Company, the relationship with employees of the Company and the Bank is good.

Internet Access to Company Documents

The Company provides access to its Securities and Exchange Commission (the "SEC") filings through a link on the Investor Relations page of the Company's website at www.amnb.com. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The information on the Company's website is not incorporated into this Annual Report on Form 10-K or any other filing the Company makes with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

Executive Officers of the Company

The following table lists, as of December 31, 2016, the executive officers of the Company, their ages, and their positions:

Name	Age	Position
Jeffrey V. Haley	56	President and Chief Executive Officer of the Company and Bank since January 2013; prior thereto, President of the Company and Chief Executive Officer of the Bank since January 2012; prior thereto, Executive Vice President of the Company from June 2010 to December 2011; prior thereto, Senior Vice President of the Company from July 2008 to May 2010; President of the Bank since June 2010; prior thereto, Executive Vice President of the Bank, as well as President of Trust and Financial Services from July 2008 to May 2010; prior thereto, Executive Vice President and Chief Operating Officer of the Bank from November 2005 to June 2007.
William W. Traynham	61	Executive Vice President, Chief Financial Officer, Treasurer and Secretary of the Company since January 2015. Executive Vice President, Chief Financial Officer, and Cashier of the Bank since April 2009.
H. Gregg Strader	58	Executive Vice President and Chief Banking Officer of the Company since January 2015. Executive Vice President and Chief Banking Officer of the Bank since January 2014. Executive Vice President of the Bank from June 2013 until December 2013. Executive Vice President and Chief Credit Officer of IBERIABANK Corporation from 2010 to June 2013.
R. Helm Dobbins	65	Executive Vice President and Chief Credit Officer of the Company since January 2015. Executive Vice President and Chief Credit Officer of the Bank since 2005.
Ramsey K. Hamadi	47	Executive Vice President of the Company since August 2016. Executive Vice President and Chief Administrative Officer of the Bank since January 2017. Executive Vice President of the Bank from July 2016 until December 2016. Executive Vice President and Chief Financial Officer for NewBridge Bancorp from April 2009 until March 2016.

ITEM 1A – RISK FACTORS

Risks Related to the Company's Business

The Company's business is subject to interest rate risk, and variations in interest rates may negatively affect financial performance.

Changes in the interest rate environment may reduce the Company's profits. It is expected that the Company will continue to realize income from the spread between the interest earned on loans, securities, and other interest earning assets, and interest paid on deposits, borrowings and other interest bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest earning assets and interest bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and the current interest rate environment encourages extreme competition for new loan originations from qualified borrowers. Management cannot ensure that it can minimize the Company's interest rate risk. While an eventual increase in the general level of interest rates may increase the loan yield and the net interest margin, it may adversely affect the ability of certain borrowers with variable rate loans to pay the interest and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect the net interest spread, asset quality, loan origination volume, and overall profitability of the Company.

The Company faces strong competition from financial services companies and other companies that offer banking and other financial services, which could negatively affect the Company's business.

The Company encounters substantial competition from other financial institutions in its market area. Ultimately, the Company may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that the Company offers. These competitors include national, regional, and community banks. The Company also faces competition from many other types of financial institutions, including savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, financial subsidiaries of certain industrial corporations, and mortgage companies. In particular, competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs and conduct extensive promotional and advertising campaigns. Increased competition may result in reduced business for the Company.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain loans and deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. If the Company is unable to attract and retain banking customers, it may be unable to continue to grow loan and deposit portfolios and its results of operations and financial condition may be adversely affected.

Changes in economic conditions could materially and negatively affect the Company's business.

The Company's business is directly impacted by economic, political, and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies, and inflation, all of which are beyond the Company's control. A deterioration in economic conditions, whether caused by global, national or local events, especially within the Company's market area, could result in potentially negative material consequences such as the following, among others: loan delinquencies increasing; problem assets and foreclosures increasing; demand for products and services decreasing; low cost or noninterest bearing deposits decreasing; and collateral for loans, especially real estate, declining in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral associated with existing loans. Each of these consequences may have a material adverse effect on the Company's financial condition and results of operations.

Trust division income is a major source of non-interest income for the Company. Trust and Brokerage fee revenue is largely dependent on the fair market value of assets under management and on trading volumes in the brokerage business. General economic conditions and their subsequent effect on the securities markets tend to act in correlation. When general economic conditions deteriorate, securities markets generally decline in value, and the Company's Trust and Brokerage fee revenue are negatively impacted as asset values and trading volumes decrease.

The Company's credit standards and its on-going credit assessment processes might not protect it from significant credit losses.

The Company takes credit risk by virtue of making loans and extending loan commitments and letters of credit. The Company manages credit risk through a program of underwriting standards, the review of certain credit decisions and an on-going process of assessment of the quality of the credit already extended. The Company's exposure to credit risk is managed through the use of consistent underwriting standards that emphasize local lending while avoiding highly leveraged transactions as well as excessive industry and other concentrations. The Company's credit administration function employs risk management techniques to help ensure that problem loans are promptly identified. While these procedures are designed to provide the Company with the information needed to implement policy adjustments where necessary and to take appropriate corrective actions, and have proven to be reasonably effective to date, there can be no assurance that such measures will be effective in avoiding future undue credit risk. The Company's focus on lending to small to mid-sized community-based businesses may increase its credit risk. Most of the Company's commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company's results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle. The deterioration of the borrowers' businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company's financial condition and results of operations. The Company depends on the accuracy and completeness of information about clients and counterparties, and its financial condition could be adversely affected if it relies on misleading information.

In deciding whether to extend credit or to enter into other transactions with clients and counterparties, the Company may rely on information furnished to it by or on behalf of clients and counterparties, including financial statements and other financial information, which the Company does not independently verify. The Company also may rely on representations of clients and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to clients, the Company may assume that a customer's audited financial statements conform with accounting principles generally accepted in the United States ("GAAP") and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. The Company's financial condition and results of operations could be negatively impacted to the extent it relies on financial statements that do not comply with GAAP or are materially misleading.

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

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

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

The Company's nonperforming assets adversely affect its net income in various ways. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases credit administration costs.

When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related asset to the then fair market value of the collateral less estimated selling costs, which may, and often does, result in a loss. An increase in the level of nonperforming assets also increases the Company's risk profile and may impact the capital levels regulators believe are appropriate in light of such risks. The Company utilizes various techniques such as workouts, restructurings and loan sales to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect the Company's business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including generation of new loans. There can be no assurance that the Company will avoid increases in nonperforming loans in the future.

A downturn in the local real estate market could materially and negatively affect the Company's business.

The Company offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity lines of credit, consumer and other loans. Many of these loans are secured by real estate (both residential and commercial) located in the Company's market area. A downturn in the real estate market in the areas in which the Company conducts its operations could negatively affect the Company's business because significant portions of its loans are secured by real estate. At December 31, 2016, the Company had approximately \$1.2 billion in loans, of which approximately \$951.1 million (81.6%) were secured by real estate. The ability to recover on defaulted loans by selling the real estate collateral could then be diminished and the Company would be more likely to suffer losses.

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

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

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

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

The Company currently depends on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company's success also depends in part on the ability to attract and retain additional qualified management personnel.

Competition for such personnel is strong and the Company may not be successful in attracting or retaining the personnel it requires.

The inability of the Company to successfully manage its growth or implement its growth strategy may adversely affect the Company's results of operations and financial condition.

The Company may not be able to successfully implement its growth strategy if it is unable to identify attractive markets, locations or opportunities to expand in the future. In addition, the ability to manage growth successfully depends on whether the Company can maintain adequate capital levels, cost controls and asset quality, and successfully integrate any businesses acquired into the Company.

As the Company continues to implement its growth strategy by opening new branches or acquiring branches or banks, it expects to incur increased personnel, occupancy and other operating expenses. In the case of new branches, the Company must absorb those higher expenses while it begins to generate new deposits; there is also further time lag involved in redeploying

new deposits into attractively priced loans and other higher yielding earning assets. The Company's plans to expand could depress earnings in the short run, even if it efficiently executes a branching strategy leading to long-term financial benefits.

Difficulties in combining the operations of acquired entities with the Company's own operations may prevent the Company from achieving the expected benefits from acquisitions.

The Company may not be able to achieve fully the strategic objectives and operating efficiencies expected in an acquisition. Inherent uncertainties exist in integrating the operations of an acquired entity. In addition, the markets and industries in which the Company and its potential acquisition targets operate are highly competitive. The Company may lose customers or the customers of acquired entities as a result of an acquisition; the Company may lose key personnel, either from the acquired entity or from itself; and the Company may not be able to control the incremental increase in noninterest expense arising from an acquisition in a manner that improves its overall operating efficiencies. These factors could contribute to the Company's not achieving the expected benefits from its acquisitions within desired time frames, if at all. Future business acquisitions could be material to the Company and it may issue additional shares of common stock to pay for those acquisitions, which would dilute current shareholders' ownership interests. Acquisitions also could require the Company to use substantial cash or other liquid assets or to incur debt; the Company could therefore become more susceptible to economic downturns and competitive pressures.

The Company is subject to extensive regulation which could adversely affect its business.

The Company's operations as a publicly traded corporation, a bank holding company, and an insured depository institution are subject to extensive regulation by federal, state, and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of the Company's operations. Because the Company's business is highly regulated, the laws, rules, and regulations applicable to it are subject to frequent and sometimes extensive change. Such changes could include higher capital requirements, increased insurance premiums, increased compliance costs, reductions of non-interest income and limitations on services that can be provided. Actions by regulatory agencies or significant litigation against the Company could cause it to devote significant time and resources to defend itself and may lead to liability or penalties that materially affect the Company and its shareholders. Any future changes in the laws, rules or regulations applicable to the Company may negatively affect the Company's business and results of operations.

Recently enacted capital standards may have an adverse effect on the Company's profitability, lending, and ability to pay dividends on the Company's securities.

In July 2013, the FRB released its final rules which implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rules, minimum requirements for both the quality and quantity of capital held by banking organizations have increased.

Consistent with the international Basel framework, the rule includes a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that applies to all supervised financial institutions. The rule also, among other things, raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and included a minimum leverage ratio of 4% for all banking organizations. The new rules became effective January 1, 2015. The potential impact of the new capital rules includes, but is not limited to, reduced lending and negative pressure on profitability and return on equity due to the higher capital requirements. To the extent the Company is required to increase capital in the future to comply with the new capital rules, its ability to pay dividends on its securities may be reduced.

New regulations issued by the Consumer Financial Protection Bureau could adversely affect the Company's earnings.

The CFPB has broad rule making authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule effective January 10, 2014, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate "qualified mortgages" that meet specific requirements with respect to terms, pricing and fees. The new rule also contains new disclosure requirements at mortgage loan origination and in monthly statements. These requirements could limit the Company's ability to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact the Company's profitability.

Changes in accounting standards could impact reported earnings.

From time to time, with increasing frequency, there are changes in the financial accounting and reporting standards that govern the preparation of the Company's financial statements. These changes can materially impact how the Company records and reports its financial condition and results of operations. In some instances, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of prior period financial statements.

Failure to maintain effective systems of internal and disclosure control could have a material adverse effect on the Company's results of operation and financial condition.

Effective internal and disclosure controls are necessary for the Company to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. If the Company cannot provide reliable financial reports or prevent fraud, its reputation and operating results would be harmed. As part of the Company's ongoing monitoring of internal control, it may discover material weaknesses or significant deficiencies in its internal control that require remediation. A "material weakness" is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis.

The Company has in the past discovered, and may in the future discover, areas of its internal controls that need improvement. Even so, the Company is continuing to work to improve its internal controls. The Company cannot be certain that these measures will ensure that it implements and maintains adequate controls over its financial processes and reporting in the future. Any failure to maintain effective controls or to timely effect any necessary improvement of the Company's internal and disclosure controls could, among other things, result in losses from fraud or error, harm the Company's reputation or cause investors to lose confidence in the Company's reported financial information, all of which could have a material adverse effect on the Company's results of operation and financial condition.

The carrying value of goodwill may be adversely impacted.

When the Company completes an acquisition, generally goodwill is recorded on the date of acquisition as an asset. Current accounting guidance requires for goodwill to be tested for impairment, which the Company performs an impairment analysis at least annually, rather than amortizing it over a period of time. A significant adverse change in expected future cash flows or sustained adverse change in the Company's common stock could require the asset to become impaired. If impaired, the Company would incur a non-cash charge to earnings that would have a significant impact on the results of operations. The carrying value of goodwill was approximately \$43.9 million at December 31, 2016.

The Company may need to raise additional capital in the future to continue to grow, but may be unable to obtain additional capital on favorable terms or at all.

Federal and state banking regulators and safe and sound banking practices require the Company to maintain adequate levels of capital to support its operations. Although the Company currently has no specific plans for additional offices, its business strategy calls for it to continue to grow in its existing banking markets (internally and through additional offices) and to expand into new markets as appropriate opportunities arise. Continued growth in the Company's earning assets, which may result from internal expansion and new branch offices, at rates in excess of the rate at which its capital is increased through retained earnings, will reduce the Company's capital ratios. If the Company's capital ratios fell below "well capitalized" levels, the FDIC deposit insurance assessment rate would increase until capital was restored and maintained at a "well capitalized" level. A higher assessment rate would cause an increase in the assessments the Company pays for federal deposit insurance, which would have an adverse effect on the Company's operating results.

Management of the Company believes that its current and projected capital position is sufficient to maintain capital ratios significantly in excess of regulatory requirements for the next several years and allow the Company flexibility in the timing of any possible future efforts to raise additional capital. However, if, in the future, the Company needs to increase its capital to fund additional growth or satisfy regulatory requirements, its ability to raise that additional capital will depend on conditions at that time in the capital markets, economic conditions, the Company's financial performance and condition, and other factors, many of which are outside its control. There is no assurance that the Company will be able to raise additional capital on terms favorable to it or at all. Any future inability to raise additional capital on terms acceptable to the Company may have a material adverse effect on its ability to expand

operations, and on its financial condition, results of operations and future prospects.

18

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

The Company's exposure to operational, technological and organizational risk may adversely affect the Company. The Company is exposed to many types of operational risks, including reputation, legal, and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems. Negative public opinion can result from the actual or alleged conduct in any number of activities, including lending practices, corporate governance, and acquisitions, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect the Company's ability to attract and retain customers and can expose it to litigation and regulatory action.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process its transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company may also be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

The Company's operations may be adversely affected by cyber security risks.

The Company relies heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in the Company's internet banking, deposit, loan, and other systems. While the Company has policies and procedures designed to prevent or limit the effect of such failure, interruption, or security breach of the Company's information systems, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of the Company's communications and information systems could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the Company to civil litigation and possible financial liability. Additionally, the Company outsources its data processing to a third party. If the Company's third party provider encounters difficulties or if the Company has difficulty in communicating with such third party, it will significantly affect the Company's ability to adequately process and account for customer transactions, which would significantly affect its business operations.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance and use of this information is critical to operations and the Company's business strategy. The Company has invested in accepted technologies, and annually reviews processes and practices that are designed to protect its networks, computers and data from damage or unauthorized access. Despite these security measures, the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. A breach in security could result in legal claims, regulatory penalties, disruption in operations, and damage to the Company's reputation, which could adversely affect the Company's business. Furthermore, as cyber threats continue to evolve and increase, the Company may be required

to expend significant additional resources to modify or enhance its protective measures, or to investigate and remediate any identified information security vulnerabilities.

Multiple major U.S. retailers, financial institutions, government agencies and departments have recently experienced data systems incursions reportedly resulting in the thefts of credit and debit card information, online account information, and other financial data of tens of millions of individuals and customers. Retailer incursions affect cards issued and deposit accounts maintained by many financial institutions, including the Bank. Although neither the Company's nor the Bank's systems are breached in government or retailer incursions, these events can cause the Bank to reissue a significant number of cards and take other costly steps to avoid significant theft loss to the Bank and its customers. In some cases, the Bank may be required to reimburse customers for the losses they incur. Other possible points of intrusion or disruption not within the Company's nor the Bank's control include internet service providers, electronic mail portal providers, social media portals, distant-server ("cloud") service providers, electronic data security providers, telecommunications companies, and smart phone manufacturers.

The Company's risk-management framework may not be effective in mitigating risk and loss.

The Company maintains an enterprise risk management program that is designed to identify, quantify, monitor, report, and control the risks that it faces. These risks include, but are not limited to: interest-rate, credit, liquidity, operations, reputation, compliance and litigation. While the Company assesses and improves this program on an ongoing basis, there can be no assurance that its approach and framework for risk management and related controls will effectively mitigate all risk and limit losses in its business. If conditions or circumstances arise that expose flaws or gaps in the Company's risk-management program, or if its controls break down, the Company's results of operations and financial condition may be adversely affected.

Current and proposed regulation addressing consumer privacy and data use and security could increase the Company's costs and impact its reputation.

The Company is subject to a number of laws concerning consumer privacy and data use and security, including information safeguard rules under the Gramm-Leach-Bliley Act. These rules require that financial institutions develop, implement and maintain a written, comprehensive information security program containing safeguards that are appropriate to the financial institution's size and complexity, the nature and scope of the financial institution's activities, and the sensitivity of any customer information at issue. The United States has experienced a heightened legislative and regulatory focus on privacy and data security, including requiring consumer notification in the event of a data breach. In addition, most states have enacted security breach legislation requiring varying levels of consumer notification in the event of certain types of security breaches. New regulations in these areas may increase the Company's compliance costs, which could negatively impact earnings. In addition, failure to comply with the privacy and data use and security laws and regulations to which the Company is subject, including by reason of inadvertent disclosure of confidential information, could result in fines, sanctions, penalties or other adverse consequences and loss of consumer confidence, which could materially adversely affect the Company's results of operations, overall business, and reputation.

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

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

Negative perception of the Company through social media may adversely affect the Company's reputation and business.

The Company's reputation is critical to the success of its business. The Company believes that its brand image has been well received by customers, reflecting the fact that the brand image, like the Company's business, is based in part on trust and confidence. The Company's reputation and brand image could be negatively affected by rapid and

widespread distribution of publicity through social media channels. The Company's reputation could also be affected by the Company's association with clients affected negatively through social media distribution, or other third parties, or by circumstances outside of the Company's control. Negative publicity, whether true or untrue, could affect the Company's ability to attract or retain customers, or cause the Company to incur additional liabilities or costs, or result in additional regulatory scrutiny.

20

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

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

Risks Related to the Company's Common Stock

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

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

Consequently, shareholders may not be able to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares. In addition, we cannot predict the effect, if any, that future sales of the Company's common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock.

Economic and other conditions may cause volatility in the price of the Company's common stock.

In the current economic environment, the prices of publicly traded stocks in the financial services sector have been volatile. However, even in a more stable economic environment the price of the Company's common stock can be affected by a variety of factors such as expected or actual results of operations, changes in analysts' recommendations or projections, announcements of developments related to its businesses, operating and stock performance of other companies deemed to be peers, news or expectations based on the performance of others in the financial services industry, and expected impacts of a changing regulatory environment. These factors not only impact the price of the Company's common stock but could also affect the liquidity of the stock given the Company's size, geographical footprint, and industry. The price for shares of the Company's common stock may fluctuate significantly in the future, and these fluctuations may be unrelated to the Company's performance. General market price declines or market volatility in the future could adversely affect the price for shares of the Company's common stock, and the current market price of such shares may not be indicative of future market prices.

Future issuances of the Company's common stock could adversely affect the market price of the common stock and could be dilutive.

The Company is not restricted from issuing additional shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, shares of common stock. Issuances of a substantial number of shares of common stock, or the expectation that such issuances might occur, including in connection with acquisitions by the Company, could materially adversely affect the market price of the shares of the common stock and could be dilutive to shareholders. Because the Company's decision to issue common stock in the future will depend on market conditions and other factors, it cannot predict or estimate the amount, timing or nature of possible future issuances of its common stock. Accordingly, the Company's shareholders bear the risk that future issuances will reduce the market price of the common stock and dilute their stock holdings in the Company.

The primary source of the Company's income from which it pays cash dividends is the receipt of dividends from its subsidiary bank.

The availability of dividends from the Company is limited by various statutes and regulations. It is possible, depending upon the financial condition of the Bank and other factors, that the OCC could assert that payment of dividends or other payments is an unsafe or unsound practice. In the event the Bank was unable to pay dividends to the Company, or be limited in the payment of such dividends, the Company would likely have to reduce or stop paying common stock dividends. The Company's reduction, limitation or failure to pay such dividends on its common stock could have a material adverse effect on the market price of the common stock.

The Company's governing documents and Virginia law contain anti-takeover provisions that could negatively impact its shareholders.

The Company's Articles of Incorporation and Bylaws and the Virginia Stock Corporation Act contain certain provisions designed to enhance the ability of the Company's Board of Directors to deal with attempts to acquire control of the Company. These provisions and the ability to set the voting rights, preferences and other terms of any series of preferred stock that may be issued, may be deemed to have an anti-takeover effect and may discourage takeovers (which certain shareholders may deem to be in their best interest). To the extent that such takeover attempts are discouraged, temporary fluctuations in the market price of the Company's common stock resulting from actual or rumored takeover attempts may be inhibited. These provisions also could discourage or make more difficult a merger, tender offer, or proxy contest, even though such transactions may be favorable to the interests of shareholders, and could potentially adversely affect the market price of the Company's common stock.

ITEM 2 – PROPERTIES

As of December 31, 2016, the Company maintained twenty-six banking offices. The Company's Virginia banking offices are located in the cities of Danville, Martinsville, Lynchburg, and in the counties of Bedford, Campbell, Franklin, Halifax, Henry, Nelson, Pittsylvania and Roanoke. In North Carolina, the Company's banking offices are located in the cities of Burlington, Greensboro, Mebane, Graham and Winston-Salem and in the counties of Alamance, Caswell, and Guilford. The Company also operates two loan production offices.

The principal executive offices of the Company are located at 628 Main Street in the business district of Danville, Virginia. This building, owned by the Company, has three floors totaling approximately 27,000 square feet.

The Company owns a building located at 103 Tower Drive in Danville, Virginia. This three-story facility serves as an operations center.

The Company has an office at 445 Mount Cross Road in Danville, Virginia where it consolidated two banking offices in January 2009 and gained additional administrative space.

The Company has an office at 3101 South Church Street in Burlington, North Carolina. This building serves as the head office for our North Carolina operations.

The Company has an office at 3000 Ogden Road in Roanoke, Virginia. The building is approximately 14,000 square feet and serves as our main office in the Roanoke market.

The Company owns fifteen other offices for a total of nineteen owned buildings. There are no mortgages or liens against any of the properties owned by the Company. The Company operates thirty-four ATMs on owned or leased facilities. The Company leases seven office locations and two storage warehouses. The Company occupies space rent-free for its limited service office in the Village of Brookwood Retirement Center under an agreement with the owners of that facility.

ITEM 3 – LEGAL PROCEEDINGS

In the ordinary course of operations, the Company and the Bank are parties to various legal proceedings. Based upon information currently available, management believes that such legal proceedings, in the aggregate, will not have a material adverse effect on the business, financial condition, or results of operations of the Company.

ITEM 4 – MINE SAFETY DISCLOSURES

None.

PART II

ITEM 5 – MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is traded on the NASDAQ Global Select Market under the symbol "AMNB." At December 31, 2016, the Company had 3,159 shareholders of record. The following table presents the high and low sales prices for the Company's common stock and dividends declared for the past two years.

2016	Sales Price		Dividends
	High	Low	Declared Per Share
1st quarter	\$26.00	\$22.29	\$ 0.24
2nd quarter	27.69	24.36	0.24
3rd quarter	28.50	24.87	0.24
4th quarter	36.25	26.41	0.24
			\$ 0.96

2015	Sales Price		Dividends
	High	Low	Declared Per Share
1st quarter	\$24.72	\$21.31	\$ 0.23
2nd quarter	24.31	21.68	0.23
3rd quarter	24.28	21.88	0.23
4th quarter	26.42	23.02	0.24
			\$ 0.93

Stock Compensation Plans

The Company maintains the 2008 Stock Incentive Plan ("2008 Plan"), which is designed to attract and retain qualified personnel in key positions, provide employees with an equity interest in the Company as an incentive to contribute to the success of the Company, and reward employees for outstanding performance and the attainment of targeted goals. The 2008 Plan and stock compensation in general is discussed in Note 13 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

The following table summarizes information, as of December 31, 2016, relating to the Company's equity based compensation plans, pursuant to which grants of options to acquire shares of common stock have been and may be granted from time to time.

	December 31, 2016		
	Number of Shares to be Issued Upon Exercise of Outstanding Options	Weighted-Average Per Share Exercise Price of Outstanding Options	Number of Shares Remaining Available for Future Issuance Under Stock Compensation Plans
Equity compensation plans approved by shareholders	58,411	\$ 24.37	120,568
Equity compensation plans not approved by shareholders	—	—	—
Total	58,411	\$ 24.37	120,568
Stock Repurchase Program			

In years prior to 2014 the Company had, in the normal course of business, operated certain stock repurchase programs. Authority to repurchase shares under these programs had been expired for some time.

On April 17, 2014, the Company filed a Form 8-K with the SEC to announce the approval by its Board of Directors of a stock repurchase program. The plan authorized the repurchase of up to 250,000 shares of the Company's common shares over a two year period. The share purchase limit was equal to approximately 3% of the 7,900,000 shares then outstanding at the time the Board approved the program.

On November 19, 2015, the Company filed a Form 8-K with the SEC to announce the approval by its Board of Directors of another stock repurchase program. The plan authorizes the repurchase of up to 300,000 shares of the Company's common shares over a two year period. The share purchase limit was equal to approximately 3.5% of the 8,622,000 shares then outstanding at the time the Board approved the program.

During 2016, the Company repurchased 51,384 shares at an average cost of \$25.14 per share, for a total cost of \$1,292,000. In 2015, the Company repurchased 150,656 shares at an average cost of \$23.27 per share, for a total cost of \$3,506,000.

No shares of the Company's common stock were repurchased during the three months ended December 31, 2016.

Under the share repurchase program, the Company has the remaining authority to repurchase up to 234,915 shares of the Company's common stock as of December 31, 2016.

Comparative Stock Performance

The following graph compares the Company's cumulative total return to its shareholders with the returns of two indexes for the five-year period ended December 31, 2016. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2011. The indexes are the NASDAQ Composite Index; the SNL Bank \$1 Billion - \$5 Billion Index, which includes bank holding companies with assets of \$1 billion to \$5 billion and is published by SNL Financial, LC.

American National Bankshares Inc.

Index	Period Ending					
	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
American National Bankshares Inc.	\$ 100.00	\$ 108.15	\$ 146.51	\$ 144.21	\$ 154.85	\$ 217.83
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
SNL Bank \$1B-\$5B	100.00	123.31	179.31	187.48	209.86	301.92

ITEM 6 - SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the Company for the last five years:

(Amounts in thousands, except per share information and ratios)

	December 31,					
	2016	2015	2014	2013	2012	
Results of Operations:						
Interest income	\$56,170	\$55,169	\$47,455	\$52,956	\$57,806	
Interest expense	6,316	5,904	5,730	6,583	8,141	
Net interest income	49,854	49,265	41,725	46,373	49,665	
Provision for loan losses	250	950	400	294	2,133	
Noninterest income	13,505	13,287	11,176	10,827	11,410	
Noninterest expense	39,801	40,543	34,558	35,105	36,643	
Income before income tax provision	23,308	21,059	17,943	21,801	22,299	
Income tax provision	7,007	6,020	5,202	6,054	6,293	
Net income	\$16,301	\$15,039	\$12,741	\$15,747	\$16,006	
Financial Condition:						
Assets	\$1,678,638	\$1,547,599	\$1,346,492	\$1,307,512	\$1,283,687	
Loans, net of unearned income	1,164,821	1,005,525	840,925	794,671	788,705	
Securities	352,726	345,661	349,250	351,013	340,533	
Deposits	1,370,640	1,262,660	1,075,837	1,057,675	1,027,667	
Shareholders' equity	201,380	197,835	173,780	167,551	163,246	
Shareholders' equity, tangible	155,789	151,280	132,692	125,349	119,543	
Per Share Information:						
Earnings per share, basic	\$1.89	\$1.73	\$1.62	\$2.00	\$2.04	
Earnings per share, diluted	1.89	1.73	1.62	2.00	2.04	
Cash dividends paid	0.96	0.93	0.92	0.92	0.92	
Book value	23.37	22.95	22.07	21.23	20.80	
Book value, tangible	18.08	17.55	16.86	15.89	15.23	
Weighted average common shares						
outstanding, basic	8,611,507	8,680,502	7,867,198	7,872,870	7,834,351	
Weighted average common shares	8,621,241	8,688,450	7,877,576	7,884,561	7,845,652	
outstanding, diluted						
Selected Ratios:						
Return on average assets	1.02	% 0.99	% 0.97	% 1.20	% 1.23	%
Return on average equity (1)	8.07	% 7.65	% 7.40	% 9.52	% 10.08	%
Return on average tangible equity (2)	10.85	% 10.62	% 10.31	% 13.75	% 15.25	%
Dividend payout ratio	50.71	% 53.65	% 56.80	% 46.03	% 45.06	%
Efficiency ratio (3)	61.47	% 63.81	% 63.41	% 57.57	% 58.23	%
Net interest margin	3.52	% 3.69	% 3.66	% 4.10	% 4.44	%
Asset Quality Ratios:						
Allowance for loan losses to period end	1.10	% 1.25	% 1.48	% 1.59	% 1.54	%
loans						
Allowance for loan losses to period end	360.39	% 242.09	% 302.21	% 248.47	% 227.95	%
non-performing loans						
Non-performing assets to total assets	0.29	% 0.48	% 0.46	% 0.65	% 0.90	%

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Net charge-offs to average loans	0.00	% 0.08	% 0.07	% (0.02	)% 0.07	%
Capital Ratios:						
Total risk-based capital ratio	14.81	% 16.34	% 17.86	% 18.14	% 17.00	%
Common equity tier 1 capital ratio	11.77	% 12.88	% n/a	n/a	n/a	%
Tier 1 capital ratio	13.83	% 15.23	% 16.59	% 16.88	% 15.75	%
Tier 1 leverage ratio	11.67	% 12.05	% 12.16	% 11.81	% 11.27	%
Tangible equity to tangible assets ratio (4)	9.54	% 10.08	% 10.00	% 9.91	% 9.64	%

26

- (1) Return on average common equity is calculated by dividing net income available to common shareholders by average common equity.
- (2) Return on average tangible common equity is calculated by dividing net income available to common shareholders plus amortization of intangibles tax effected by average common equity less average intangibles.
The efficiency ratio is calculated by dividing noninterest expense excluding gains or losses on the sale of other real estate owned by net interest income including tax equivalent income on nontaxable loans and securities and excluding (a) gains or losses on securities and (b) gains or losses on sale of premises and equipment.
- (3) Tangible equity to tangible assets ratio is calculated by dividing period-end common equity less period-end intangibles by period-end assets less period-end intangibles.
- (4)

ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on significant changes in the financial condition and results of operations of the Company during the past three years. The discussion and analysis are intended to supplement and highlight information contained in the accompanying Consolidated Financial Statements and the selected financial data presented elsewhere in this Annual Report on Form 10-K.

RECLASSIFICATION

In certain circumstances, reclassifications have been made to prior period information to conform to the 2016 presentation. There were no material reclassifications.

CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with GAAP and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses, (2) mergers and acquisitions, (3) acquired loans with specific credit-related deterioration, (4) goodwill and intangible assets, (5) other real estate owned, (6) deferred tax assets and liabilities, (7) other-than-temporary impairment of securities and (8) the unfunded pension liability. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements.

The financial information contained within the Company's financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset, or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method.

Allowance for Loan Losses

The purpose of the allowance for loan losses ("ALLL") is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The goal of the Company is to maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and the provision for loan loss expense.

The Company uses certain practices to manage its credit risk. These practices include (1) appropriate lending limits for loan officers, (2) a loan approval process, (3) careful underwriting of loan requests, including analysis of borrowers, cash flows, collateral, and market risks, (4) regular monitoring of the portfolio, including diversification by type and geography, (5) review of loans by the Loan Review department, which operates independently of loan production (the Loan Review function consists of a co-sourced arrangement using both internal personnel and external vendors to provide the Company with a more robust review function of the loan portfolio), (6) regular meetings of the Credit Committee to discuss portfolio and policy changes and make decisions on large or unusual loan requests, and (7) regular meetings of the Asset Quality Committee which reviews the status of individual loans.

Risk grades are assigned as part of the loan origination process. From time to time, risk grades may be modified as warranted by the facts and circumstances surrounding the credit.

Calculation and analysis of the ALLL is prepared quarterly by the Finance Department. The Company's Credit Committee, Capital Management Committee, Audit Committee, and the Board of Directors review the allowance for adequacy.

The Company's ALLL has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates and judgments.

The formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, and portfolio concentrations, regulatory, legal, competition, quality of loan review system, and value of underlying collateral. In the formula allowance for commercial and commercial real estate loans, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. Allowance calculations for residential real estate and consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category.

The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. These include:

The present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan);

• The loan's observable market price, or

• The fair value of the collateral, net of estimated costs to dispose, if the loan is collateral dependent.

The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

No single statistic, formula, or measurement determines the adequacy of the allowance. Management makes subjective and complex judgments about matters that are inherently uncertain, and different amounts would be reported under different conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific loan categories and specific loans. However, the entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified losses.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period as facts and circumstances evolve. Furthermore, management cannot provide assurance that in any particular period the Bank will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time.

Mergers and Acquisitions

Business combinations are accounted for under the Financial Accounting Standards Board (the "FASB") Accounting Standards Codification ("ASC") 805, Business Combinations, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company will rely on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analysis or other valuation techniques. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of costs to the Company include systems conversions, integration planning, consultants, and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities will be recognized in accordance with other applicable GAAP. These acquisition-related costs have been and will be included within the Consolidated Statements of Income classified within the noninterest expense caption.

Acquired Loans with Specific Credit-Related Deterioration

Acquired loans with specific credit deterioration are accounted for by the Company in accordance with FASB ASC 310-30, Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality. Certain acquired loans, those for which specific credit-related deterioration, since origination, is identified, are recorded at fair value reflecting

the present value of the amounts expected to be collected. Income recognition on these loans is based on a reasonable expectation about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretable yield.

Goodwill and Intangible Assets

The Company follows ASC 350, Goodwill and Other Intangible Assets, which prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired.

Goodwill resulting from business combinations after January 1, 2009 is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exist that indicate that a goodwill impairment test should be performed. The Company has selected June 30 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives, which range from 8.25 to 10 years, to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the Company's consolidated balance sheets. No indicators of impairment were identified during the years ended December 31, 2016, 2015, and 2014.

Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of similar properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Company may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further deterioration in market conditions.

Deferred Tax Assets and Liabilities

The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. Management considers all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed.

Other-than-temporary Impairment of Securities

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we 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. For equity securities, impairment is considered to be other-than-temporary based on our 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. We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

Unfunded Pension Liability

The Company previously maintained a non-contributory, defined benefit pension plan for eligible full-time employees as specified by the plan. The Company froze its pension plan to new participants and converted its pension plan to a cash balance plan effective December 31, 2009. Plan assets, which consist primarily of mutual funds invested in marketable equity securities and corporate and government fixed income securities, are valued using market quotations. 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 interest crediting rate, the estimated future return on

plan assets and the anticipated rate of future salary 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.

NON-GAAP PRESENTATIONS

Non-GAAP presentations are provided because the Company believes these may be valuable to investors. These include (1) the analysis of net interest income presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets and (2) the calculation of the efficiency ratio.

The efficiency ratio is calculated by dividing noninterest expense excluding gains or losses on the sale of other real estate owned ("OREO") by net interest income including tax equivalent income on nontaxable loans and securities and noninterest income and excluding (i) gains or losses on securities and (ii) gains or losses on sale of premises and equipment. The efficiency ratio for 2016, 2015, and 2014 was 61.47%, 63.81%, and 63.41%, respectively. The Company expects continued improvement in this ratio in 2017. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with GAAP and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the following table (dollars in thousands):

	Year Ended December 31,		
	2016	2015	2014
Efficiency Ratio			
Noninterest expense	\$39,801	\$40,543	\$34,558
Add/Subtract: loss/(gain) on sale OREO	(228)	99	(2)
	\$39,573	\$40,642	\$34,556
Net interest income	\$49,854	\$49,265	\$41,725
Tax equivalent adjustment	1,846	2,014	2,088
Noninterest income	13,505	13,287	11,176
Subtract: gain on securities	(836)	(867)	(505)
Add/Subtract: (gain)/loss on sale of fixed assets	9	(11)	10
	\$64,378	\$63,688	\$54,494
Efficiency ratio	61.47	% 63.81	% 63.41 %

Net interest margin is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2016, 2015, and 2014 is 35%. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below (in thousands):

	Year Ended December 31,		
	2016	2015	2014
Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income			
Non-GAAP measures:			
Interest income - loans	\$48,224	\$46,985	\$39,298
Interest income - investments and other	9,792	10,198	10,245
Interest expense - deposits	(5,103)	(4,811)	(4,654)
Interest expense - customer repurchase agreements	(5)	(9)	(7)
Interest expense - other short-term borrowings	(5)	—	(2)
Interest expense - long-term borrowings	(1,203)	(1,084)	(1,067)
Total net interest income	\$51,700	\$51,279	\$43,813
Less non-GAAP measures:			
Tax benefit realized on non-taxable interest income - loans	\$(253)	\$(125)	\$(41)
Tax benefit realized on non-taxable interest income - municipal securities	(1,593)	(1,889)	(2,047)
GAAP measures	\$49,854	\$49,265	\$41,725

INTERNET ACCESS TO CORPORATE DOCUMENTS

The Company provides access to its SEC filings through a link on the Investor Relations page of the Company's website at www.amnb.com. Reports available include annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The information on the Company's website is not incorporated into this report or any other filing the Company makes with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

ACQUISITION OF MAINSTREET BANKSHARES, INC.

On January 1, 2015, the Company completed its acquisition of MainStreet. The merger of MainStreet with and into the Company was effected pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between the Company and MainStreet. Immediately after the merger of MainStreet into the Company, Franklin Bank, MainStreet's wholly-owned bank subsidiary, merged with and into the Bank.

Pursuant to the MainStreet merger agreement, the former holders of shares of MainStreet common stock received \$3.46 in cash and 0.482 shares of the Company's common stock for each share of MainStreet common stock held immediately prior to the effective date of the merger, plus cash in lieu of fractional shares. Each option to purchase shares of MainStreet common stock that was outstanding immediately prior to the effective date of the merger vested upon the merger and was converted into an option to purchase shares of the Company's common stock, adjusted based on a 0.643 exchange ratio. Each share of the Company's common stock outstanding immediately prior to the merger remained outstanding and was unaffected by the merger. The cash portion of the merger consideration was funded through a cash dividend of \$6,000,000 from the Bank to the Company, and no borrowing was incurred by the Company or the Bank in connection with the merger.

MainStreet was the holding company for Franklin Bank. Immediately prior to the Company's acquisition of MainStreet on January 1, 2015, MainStreet had net loans of approximately \$122,000,000, total assets of approximately \$164,000,000, and total deposits of approximately \$137,000,000. Franklin Community Bank, N.A. provided banking services to its customers from three banking offices located in Rocky Mount, Hardy, and Union Hall, Virginia, which are now branch offices of the Bank.

STRATEGIC EVENT

The Company announced in September 2016 its plans to form a de novo branch in each of Roanoke, Virginia, and Winston-Salem, North Carolina. Initial staffing for Roanoke included fifteen full-time equivalent employees. Initial staffing for Winston-Salem included five full-time equivalent employees. Initial operations from both offices impacted the fourth quarter of 2016 earning assets and operating results.

RESULTS OF OPERATIONS

Net Income

Net income for 2016 was \$16,301,000 compared to \$15,039,000 for 2015, an increase of \$1,262,000 or 8.4%. Basic and diluted earnings per share were \$1.89 for 2016 compared to \$1.73 for 2015. This net income produced for 2016 a return on average assets of 1.02%, a return on average equity of 8.07%, and a return on average tangible equity of 10.85%.

Net income for 2015 was \$15,039,000 compared to \$12,741,000 for 2014, an increase of \$2,298,000 or 18.0%. Basic and diluted earnings per share were \$1.73 for 2015 compared to \$1.62 for 2014. This net income produced for 2015 a return on average assets of 0.99%, a return on average equity of 7.65%, and a return on average tangible equity of 10.62%.

Earnings for 2016, 2015, and 2014 were favorably impacted by the 2011 acquisition of MidCarolina and the 2015 acquisition of MainStreet. The financial impact of the mergers was mostly a significant increase in earning assets.

Net Interest Income

Net interest income is the difference between interest income on earning assets, primarily loans and securities, and interest expense on interest bearing liabilities, primarily deposits. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income. The 2011 acquisition of MidCarolina and the 2015 acquisition of MainStreet impacted net interest income positively for 2016 and 2015, through increased earning assets.

The following discussion of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets, such as certain state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent basis. Net interest income divided by average earning assets is referred to as the net interest margin. The net interest spread represents the difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities. All references in this section relate to average yields and rates and average asset and liability balances during the periods discussed.

Net interest income on a taxable equivalent basis increased \$421,000 or 0.8% in 2016 from 2015, following a \$7,466,000 or 17.0% increase in 2015 from 2014. The increase in net interest income in 2016 was primarily due to increased volumes of earning assets related to organic growth.

Yields on loans were 4.54% in 2016 compared to 4.81% in 2015. Cost of funds was 0.60% in 2016 compared to 0.58% in 2015. Between 2016 and 2015, deposit rates for demand accounts increased to 0.05% from 0.04%, money market accounts increased to 0.18% from 0.13%, and time deposits increased to 1.14% from 1.09%. Management regularly reviews deposit pricing and attempts to keep costs as low as possible, while remaining competitive. The net interest margin was 3.52% for 2016, 3.69% for 2015, and 3.66% for 2014.

During 2008, the Federal Open Market Committee ("FOMC") of the FRB reduced the federal funds rate seven times from 4.25% to 0.25%, where it remained, unchanged, through mid December 2015. On December 17, 2015, the FOMC raised the target federal funds rate from 0.25% to 0.50%. On December 15, 2016, the FOMC raised the target federal funds rate from 0.50% to 0.75%. The increase in rates is expected to have a nominal positive impact on net interest income. Given recent economic and geopolitical events in 2016 and early 2017, the federal funds rate may be higher at year end 2017, but there is considerable uncertainty as to how much higher it may be.

Net interest income on a taxable equivalent basis increased \$7,466,000 or 17.0% in 2015 from 2014, following a \$4,819,000 or 9.9% decrease in 2014 from 2013. The increase in net interest income in 2015 was primarily due to increased volumes of earning assets and accretion income related to the MainStreet acquired loan portfolio, and accounted for \$6,430,000 or 86% of the total increase.

Yields on loans were 4.81% in 2015 compared to 4.88% in 2014. Cost of funds was 0.58% in 2015 compared to 0.64% in 2014. Between 2015 and 2014, deposit rates for demand, money market, and savings accounts remained

basically stable while time deposit rates decreased to 1.09% from 1.17%. Management regularly reviews deposit pricing and attempts to keep costs

32

as low as possible, while remaining competitive. The net interest margin was 3.69% for 2015, 3.66% for 2014, and 4.10% for 2013.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the last three years. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

33

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Net Interest Income Analysis

(in thousands, except yields and rates)

	Average Balance			Interest Income/Expense			Average Yield/Rate		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Loans:									
Commercial	\$ 198,326	\$ 156,646	\$ 122,434	\$ 7,856	\$ 6,893	\$ 5,436	3.96 %	4.40 %	4.44 %
Real estate	859,721	809,545	677,633	39,763	39,362	33,508	4.63	4.86	4.94
Consumer	5,230	9,669	4,792	605	730	354	11.57	7.55	7.39
Total loans	1,063,277	975,860	804,859	48,224	46,985	39,298	4.54	4.81	4.88
Securities:									
Federal agencies and GSEs	96,009	88,384	74,390	1,674	1,364	852	1.74	1.54	1.15
Mortgage-backed and CMOs	79,720	61,741	61,377	1,635	1,346	1,453	2.05	2.18	2.37
State and municipal	160,279	183,208	187,595	5,647	6,746	7,307	3.52	3.68	3.90
Other securities	15,953	15,783	15,106	560	532	477	3.51	3.37	3.16
Total securities	351,961	349,116	338,468	9,516	9,988	10,089	2.70	2.86	2.98
Federal funds sold	—	5,230	—	—	6	—	—	0.11	—
Deposits in other banks	55,410	61,280	52,768	276	204	156	0.50	0.33	0.30
Total interest earning assets	1,470,648	1,391,486	1,196,095	58,016	57,183	49,543	3.94	4.11	4.14
Nonearning assets	127,501	132,280	116,377						
Total assets	\$ 1,598,149	\$ 1,523,766	\$ 1,312,472						
Deposits:									
Demand	\$ 216,521	\$ 223,825	\$ 183,994	99	82	71	0.05	0.04	0.04
Money market	239,262	196,828	177,046	432	260	232	0.18	0.13	0.13
Savings	118,144	109,697	88,629	47	53	47	0.04	0.05	0.05
Time	396,801	404,366	368,712	4,525	4,416	4,304	1.14	1.09	1.17
Total deposits	970,728	934,716	818,381	5,103	4,811	4,654	0.53	0.51	0.57
Customer repurchase agreements	46,832	48,105	43,724	5	9	7	0.01	0.02	0.02
Other short-term borrowings	656	14	701	5	—	2	0.76	0.36	0.29
Long-term borrowings	37,640	37,515	37,398	1,203	1,084	1,067	3.20	2.89	2.85
Total interest bearing liabilities	1,055,856	1,020,350	900,204	6,316	5,904	5,730	0.60	0.58	0.64
Noninterest bearing demand deposits	330,315	297,483	234,149						
Other liabilities	9,904	9,415	5,912						
Shareholders' equity	202,074	196,518	172,207						
Total liabilities and shareholders' equity	\$ 1,598,149	\$ 1,523,766	\$ 1,312,472						
Interest rate spread							3.34 %	3.53 %	3.50 %
Net interest margin							3.52 %	3.69 %	3.66 %
Net interest income (taxable equivalent basis)				51,700	51,279	43,813			

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Less: Taxable equivalent adjustment	1,846	2,014	2,088
Net interest income	\$49,854	\$49,265	\$41,725

34

The following table presents the dollar amount of changes in interest income and interest expense, and distinguishes between changes resulting from fluctuations in average balances of interest earning assets and interest bearing liabilities (volume), and changes resulting from fluctuations in average interest rates on such assets and liabilities (rate). Changes attributable to both volume and rate have been allocated proportionately (dollars in thousands):

Changes in Net Interest Income (Rate / Volume Analysis)

	2016 vs. 2015			2015 vs. 2014		
	Increase	Change Attributable to		Increase	Change Attributable to	
	(Decrease)	Rate	Volume	(Decrease)	Rate	Volume
Interest income						
Loans:						
Commercial	\$963	\$(738)	\$1,701	\$1,457	\$(49)	\$1,506
Real estate	401	(1,972)	2,373	5,854	(568)	6,422
Consumer	(125)	293	(418)	376	8	368
Total loans	1,239	(2,417)	3,656	7,687	(609)	8,296
Securities:						
Federal agencies and GSEs	310	186	124	512	332	180
Mortgage-backed and CMOs	289	(84)	373	(107)	(116)	9
State and municipal	(1,099)	(282)	(817)	(561)	(393)	(168)
Other securities	28	22	6	55	33	22
Total securities	(472)	(158)	(314)	(101)	(144)	43
Federal funds sold	(6)	6	(12)	6	6	—
Deposits in other banks	72	93	(21)	48	21	27
Total interest income	833	(2,476)	3,309	7,640	(726)	8,366
Interest expense						
Deposits:						
Demand	17	20	(3)	11	(4)	15
Money market	172	108	64	28	2	26
Savings	(6)	(10)	4	6	(4)	10
Time	109	193	(84)	112	(288)	400
Total deposits	292	311	(19)	157	(294)	451
Customer repurchase agreements	(4)	(4)	—	2	1	1
Other borrowings	124	101	23	15	31	(16)
Total interest expense	412	408	4	174	(262)	436
Net interest income	\$421	\$(2,884)	\$3,305	\$7,466	\$(464)	\$7,930

Noninterest Income

For the year ended December 31, 2016, noninterest income increased \$218,000 or 1.6% compared to the year ended December 31, 2015. Details of individual accounts are shown in the table on the following page.

	Years Ended December 31, (Dollars in thousands)			
	2016	2015	\$ Change	% Change
Noninterest income:				
Trust fees	\$3,791	\$3,935	\$(144)	(3.7)%
Service charges on deposit accounts	2,048	2,066	(18)	(0.9)
Other fees and commissions	2,680	2,377	303	12.7
Mortgage banking income	1,713	1,320	393	29.8
Securities gains, net	836	867	(31)	(3.6)
Brokerage fees	843	946	(103)	(10.9)
Income from Small Business Investment Companies	463	912	(449)	(49.2)
Other	1,131	864	267	30.9
Total noninterest income	\$13,505	\$13,287	\$218	1.6%

A substantial portion of trust fees are earned based on account fair values, so changes in the equity markets may have a large and potentially volatile impact on revenue. Trust income and service charge income decreased slightly for 2016 compared to 2015. Other fees and commissions were positively impacted by higher levels of debit card transaction volume. Mortgage banking income increased significantly in 2016 as a result of increases in the volume of originations. Secondary market mortgage loan volume for 2016 was \$78,330,000 compared to \$59,030,000 for 2015. Income from Small Business Investment Company ("SBIC") investments, which is volatile and difficult to predict, decreased \$449,000 or 49.2% for 2016 compared to 2015. Other income increased \$267,000 for 2016 compared to 2015 primarily due to the additional income from investments in limited partnerships.

	Years Ended December 31, (Dollars in thousands)			
	2015	2014	\$ Change	% Change
Noninterest income:				
Trust fees	\$3,935	\$4,196	\$(261)	(6.2)%
Service charges on deposit accounts	2,066	1,735	331	19.1
Other fees and commissions	2,377	1,903	474	24.9
Mortgage banking income	1,320	1,126	194	17.2
Securities gains, net	867	505	362	71.7
Brokerage fees	946	643	303	47.1
Income from Small Business Investment Companies	912	176	736	418.2
Other	864	892	(28)	(3.1)
Total noninterest income	\$13,287	\$11,176	\$2,111	18.9%

A substantial portion of trust fees are earned based on account fair values, so changes in the equity markets may have a large and potentially volatile impact on revenue. Trust income decreased for 2015 compared to 2014, largely related to the 2014 recognition of a one-time estate fee revenue of approximately \$110,000. Trust income was not immediately impacted by the MainStreet acquisition. Service charge income was positively impacted by increases in overdraft and returned check fee income and higher fee income from debit card activity. These categories were higher based on larger transaction volume. Mortgage banking income was higher in 2015 based on greater loan demand volume in existing markets and the impact of the MainStreet acquisition. Secondary market mortgage loan volume for 2015 was \$59,030,000 compared to \$49,565,000 for 2014. Securities gains also increased, which related to the Company's decision to reduce its exposure to states with unusually large unfunded pension obligations and states sensitive to the large decline in the price of oil, notably Texas. Income from SBIC investments, which is volatile and difficult to predict, increased \$736,000 or 418.2% for 2015 compared to 2014.

Noninterest Expense

For the year ended December 31, 2016, noninterest expense decreased \$742,000 or 1.8% as compared to the year ended December 31, 2015.

	Years Ended December 31,			
	(Dollars in thousands)			
	2016	2015	\$	%
			Change	Change
Noninterest Expense:				
Salaries	\$17,568	\$16,554	\$1,014	6.1 %
Employee benefits	4,264	4,311	(47)	(1.1)
Occupancy and equipment	4,246	4,425	(179)	(4.0)
FDIC assessment	647	750	(103)	(13.7)
Bank franchise tax	995	898	97	10.8
Core deposit intangible amortization	964	1,201	(237)	(19.7)
Data processing	1,828	1,725	103	6.0
Software	1,143	1,158	(15)	(1.3)
Other real estate owned, net	336	99	237	239.4
Merger related expenses	—	1,998	(1,998)	(100.0)
Other	7,810	7,424	386	5.2
Total noninterest expense	\$39,801	\$40,543	\$(742)	(1.8) %

Salaries expense increased \$1,014,000, or 6.1%, in 2016 compared to 2015. The major driver of this increase is additional compensation expense related to the de novo efforts in Roanoke, Virginia and Winston-Salem, North Carolina. The expense for FDIC assessment decreased in 2016 due to the reduction in FDIC assessment rates effective the third quarter of 2016. Other real estate owned expense includes gains and losses on sale of foreclosed properties, adjustments related to re-appraisals of foreclosed properties, and operating expenses related to maintaining foreclosed properties. It is inherently volatile from period to period. The change in other real estate owned expense during 2016 was primarily a result of the gain on the sale of one foreclosed property in the amount of \$183,000 during 2015. The largest component of the decrease in noninterest expense in 2016 was the 2015 nonrecurring merger related expenses of \$1,998,000.

	Years Ended December 31,			
	(Dollars in thousands)			
	2015	2014	\$	%
			Change	Change
Noninterest Expense:				
Salaries	\$16,554	\$14,688	\$1,866	12.7 %
Employee benefits	4,311	2,988	1,323	44.3
Occupancy and equipment	4,425	3,727	698	18.7
FDIC assessment	750	647	103	15.9
Bank franchise tax	898	901	(3)	NM
Core deposit intangible amortization	1,201	1,114	87	7.8
Data processing	1,725	1,448	277	19.1
Software	1,158	1,019	139	13.6
Other real estate owned, net	99	240	(141)	(58.8)
Merger related expenses	1,998	780	1,218	156.2
Other	7,424	7,006	418	6.0
Total noninterest expense	\$40,543	\$34,558	\$5,985	17.3 %
NM - Not meaningful				

Salaries expense increased significantly in 2015 compared to 2014 primarily related to the MainStreet acquisition. The increase in salaries expense represents 31.2% of the total increase in noninterest expense between 2015 and 2014. Total full time equivalent employees increased to 303 in 2015 from 284 in 2014. Employee benefits were impacted by the acquisition and also increased health care and pension settlement expense. Data processing expense increased due to higher transaction volumes, increased usage of the Company's core information management system, and also a delay in the operational conversion for MainStreet from March to May 2015. Other real estate owned expense includes gains and losses on sale of foreclosed properties, adjustments related to re-appraisals of foreclosed properties, and operating expenses related to maintaining foreclosed properties. It is inherently volatile from period to period. Nonrecurring MainStreet acquisition related expenses represent 20.4% of the total increase in noninterest expense between 2015 and 2014.

OREO expense, includes gains and losses on sale of foreclosed properties, adjustments related to re-appraisals of foreclosed properties, and operating expenses related to maintaining foreclosed properties. The activity related to this noninterest expense for the years ended December 31, 2016, 2015, and 2014 are shown below (dollars in thousands):

	2016	2015	2014
(Gain) loss on sale of OREO	\$72	\$(185)	\$(66)
OREO valuation adjustments	156	86	68
OREO related expense	108	198	238
	\$336	\$99	\$240

Income Taxes

Income taxes on 2016 earnings amounted to \$7,007,000, resulting in an effective tax rate of 30.1%, compared to 28.6% in 2015 and 29.0% in 2014. The effective tax rate is lower than the statutory rate of 35% due to income that is not taxable for federal income tax purposes. The primary non-taxable income is that of state and municipal securities and loans. The increase in the effective tax rate is primarily related to a lower level of tax exempt municipal securities income.

Fair Value Impact to Pretax Income

The July 2011 merger with MidCarolina and the January 2015 merger with MainStreet had a material and positive impact on earnings. The ongoing financial impact of the mergers was mostly the result of the increase in earnings assets. However, the specific financial impact of the fair value related accounting adjustments is reflected in the following tables. The tables present the actual effect of the accretible and amortizable fair value adjustments attributable to the mergers on net interest income and pretax income for the years ended December 31, 2016, 2015, and 2014, respectively (dollars in thousands):

			December 31, 2016		
	Income Statement Effect	Premium/(Discount) Balance on December 31, 2015	Accretion (Amortization) For the year ended	Remaining Premium/(Discount) Balance	
Interest income/(expense):					
Acquired performing loans	Income	\$ (3,061)	\$ 1,085	\$ (1,976)	
Purchased impaired loans	Income	(7,066)	1,357	(5,709) (1)	
FHLB advances	Expense	42	(22)	20	
Junior subordinated debt	Expense	1,761	(102)	1,659	
Net Interest Income			2,318		
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 2,683	(964)	\$ 1,719	
Net non-interest expense			(964)		
Change in pretax income			\$ 1,354		
(1) Remaining discount balance includes \$2,197,000 in reclassifications from the non-accretible difference.					
			December 31, 2015		
	Income Statement Effect	Premium/(Discount) Balance on December 31, 2014	Additions for the year ended	Accretion (Amortization) For the year ended	Remaining Premium/(Discount) Balance
Interest income/(expense):					
Acquired performing loans	Income	\$ (3,358)	\$(1,279)	\$ 1,576	\$ (3,061)
Purchased impaired loans	Income	(3,424)	(5,097)	1,455	(7,066) (1)
Time deposits	Income	—	(288)	288	—
Time deposits - brokered	Income	—	(2)	2	—
FHLB advances	Expense	65	—	(23)	42
Junior subordinated debt	Expense	1,862	—	(101)	1,761
Net Interest Income			(6,666)	3,197	
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 2,045	1,839	(1,201)	\$ 2,683
Net non-interest expense			1,839	(1,201)	
Change in pretax income			\$(4,827)	\$ 1,996	
(1) Remaining discount balance includes \$238,000 in reclassifications from the non-accretible difference.					

				December 31, 2014	
	Income Statement Effect	Premium/(Discount) Balance on December 31, 2013		Accretion (Amortization) For the year ended	Remaining Premium/(Discount) Balance
Interest income/(expense):					
Acquired performing loans	Income	\$ (5,010 )	)	\$ 1,608	\$ (3,358) (1)
Purchased impaired loans	Income	(4,371 )	)	947	(3,424) (2)
FHLB advances	Expense	87		(22)	65
Junior subordinated debt	Expense	1,964		(102)	1,862
Net Interest Income				2,431	
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 2,969		(924)	\$ 2,045
Net non-interest expense				(924)	
Change in pretax income				\$ 1,507	

(1) Remaining discount balance includes \$35,000 of mark moved to OREO and \$9,000 of charge-offs against the mark.

(2) Remaining discount balance includes \$579,000 in reclassifications from the non-accretable difference.

Generally accepted accounting principles for business combinations require the acquired balance sheet to be valued at fair value at the time of the merger. In the context of acquiring a commercial bank, most of the balance sheet is interest rate sensitive and this can generate significant discounts or premiums to contractual values. These discounts or premiums will have potentially significant impact to net interest income and to net income.

The table below summarizes the impact of the fair value merger related accounting impact to net interest income and impact to pretax income of the MidCarolina ("MC") and MainStreet ("MS") acquisitions (dollars in thousands):

	For the Years Ended December 31, 2016			2015			2014		
	MC	MS	Total	MC	MS	Total	MC	MS	Total
Net interest income	\$1,450	\$868	\$2,318	\$2,268	\$929	\$3,197	\$2,431	\$—	\$2,431
Core deposit amortization	(717)	(247)	(964)	(906)	(295)	(1,201)	(924)	—	(924)
Total pretax income	\$733	\$621	\$1,354	\$1,362	\$634	\$1,996	\$1,507	\$—	\$1,507

The MidCarolina acquisition was effective July 1, 2011. The MainStreet acquisition was effective January 1, 2015. Management expects that the fair value accounting financial impact of both acquisitions will continue to decline in subsequent quarters.

Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The most significant effect of inflation is on noninterest expenses that tend to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Company has the ability to react to those changes and measure and monitor its interest rate and liquidity risk.

Market Risk Management

Effectively managing market risk is essential to achieving the Company's financial objectives. Market risk reflects the risk of economic loss resulting from changes in interest rates and market prices. The Company is generally not subject to currency exchange risk or commodity price risk. The Company's primary market risk exposure is interest rate risk; however, market risk also includes liquidity risk. Both are discussed in the following sections.

Interest Rate Risk Management

Interest rate risk and its impact on net interest income is a primary market risk exposure. The Company manages its exposure to fluctuations in interest rates through policies approved by its Asset Liability Committee ("ALCO") and Board of Directors, both of which receive and review periodic reports of the Company's interest rate risk position. The Company uses computer simulation analysis to measure the sensitivity of projected earnings to changes in interest rates. Simulation takes into account current balance sheet volumes and the scheduled repricing dates, instrument level optionality, and maturities of assets and liabilities. It incorporates numerous assumptions including growth, changes in the mix of assets and liabilities, prepayments, and average rates earned and paid. Based on this information, management uses the model to project net interest income under multiple interest rate scenarios.

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster or to a greater extent than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce relatively more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position at December 31, 2016 is asset sensitive. As of early 2017, management expects that the general direction of market interest rates will be stable to up, though volatility, sometimes substantial, is anticipated in the short-term.

Earnings Simulation

The table below shows the estimated impact of changes in interest rates on net interest income as of December 31, 2016 (dollars in thousands), assuming gradual and parallel changes in interest rates, and consistent levels of assets and liabilities. Net interest income for the following twelve months is projected to increase when interest rates are higher than current rates.

Estimated Changes in Net Interest Income

Change in interest rates	December 31, 2016	
	Amount	Percent
Up 4.0%	\$6,565	12.3 %
Up 3.0%	5,114	9.5
Up 2.0%	3,548	6.6
Up 1.0%	1,813	3.4
Flat	—	—
Down 0.25%	(716)	(1.3)
Down 0.50%	(1,730)	(3.2)

Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Interest rate shifts may not be parallel.

Changes in interest rates can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Company's interest rate sensitivity position. Additionally, credit risk may rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

Economic Value Simulation

Economic value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Economic values are calculated based on discounted cash flow analysis. The net economic value of equity is the economic value of all assets minus the economic value of all liabilities. The change in net economic value over different rate environments is an indication of the longer-term earnings capability of the balance sheet. The same assumptions are used in the economic value simulation as in the earnings simulation. The economic value simulation uses instantaneous rate shocks to the balance sheet.

The following table reflects the estimated change in net economic value over different rate environments using economic value simulation for the balances at the period ended December 31, 2016 (dollars in thousands):

Estimated Changes in Economic Value of Equity

December 31, 2016

Change in interest rates	Amount	\$ Change	% Change
Up 4%	\$272,633	\$40,063	17.2 %
Up 3%	271,710	39,140	16.8
Up 2%	267,298	34,728	14.9
Up 1%	255,244	22,674	9.7
Flat	232,570	—	—
Down 0.25%	224,551	(8,019)	(3.4)
Down 0.50%	215,626	(16,944)	(7.3)

Liquidity Risk Management

Liquidity is the ability of the Company in a timely manner to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities. Liquidity management involves maintaining the Company's ability to meet the daily cash flow requirements of its customers, whether they are borrowers requiring funds or depositors desiring to withdraw funds. Additionally, the Company requires cash for various operating needs including dividends to shareholders, the servicing of debt, and the payment of general corporate expenses. The Company manages its exposure to fluctuations in interest rates and liquidity needs through policies approved by the ALCO and Board of Directors, both of which receive periodic reports of the Company's interest rate risk and liquidity position. The Company uses a computer simulation model to assist in the management of the future liquidity needs of the Company.

Liquidity sources include on balance sheet and off balance sheet sources.

Balance sheet liquidity sources include cash, amounts due from banks, loan repayments, bond maturities and calls, and increases in deposits. Further, the Company maintains a large, high quality, very liquid bond portfolio, which is generally 50% to 60% unpledged and would, accordingly, be available for sale if necessary.

Off balance sheet sources include lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB"), federal funds lines of credit, and access to the Federal Reserve Bank of Richmond's discount window.

The Company has a line of credit with the FHLB, equal to 30% of the Company's assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, home equity lines of credit, commercial real estate loans and commercial construction loans. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. At December 31, 2016, principal advance obligations to the FHLB consisted of \$9,980,000 in fixed-rate, long-term advances and \$20,000,000 in variable-rate, short-term advances compared to \$9,958,000 in long-term advances and no short-term advances at December 31, 2015. The Company also had outstanding \$130,700,000 in letters of credit at December 31, 2016 compared to \$70,700,000 in letters of credit at December 31, 2015. The letters of credit provide the Bank with additional collateral for securing public entity deposits above FDIC insurance levels, thereby providing less need for collateral pledging from the securities portfolio and accordingly increasing our balance sheet liquidity.

Short-term borrowing is discussed in Note 10 and long-term borrowing is discussed in Note 11 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 each and has access to the Federal Reserve Bank of Richmond's discount window. There were no amounts outstanding under these facilities at December 31, 2016. The Company, through its subsidiary bank, has a relationship with Promontory Network, the sponsoring entity for the Certificate of Deposit Account Registry Service® ("CDARS"). Through CDARS, the Company is able to provide deposit customers with access to aggregate FDIC insurance in amounts far exceeding \$250,000. This gives the Company the ability, as and when needed, to attract and retain large deposits from insurance sensitive customers. CDARS are classified as brokered deposits, however they

are generally derived from customers with whom our institution has or wishes to have a direct and ongoing core deposit relationship. As a result, management considers these deposits functionally, though not technically, in the same category as core deposits. With CDARS, the Company has the option to keep deposits on balance sheet or sell them to other members of the network. Additionally, subject to certain limits, the Company can use CDARS to purchase

42

cost-effective funding without collateralization and in lieu of generating funds through traditional brokered CDs or the FHLB. Thus, CDARS serves as a deposit-gathering tool and an additional liquidity management tool. Deposits through the CDARS program as of December 31, 2016 and 2015 were \$23,445,000 and \$23,633,000, respectively. The Bank also participates with the Promontory Network using Insured Cash Sweep®, a product which provides the Bank the capability of providing additional deposit insurance to customers in the context of a money market account arrangement. The product is analogous to the CDARS product discussed above.

Management believes that these sources provide sufficient and timely liquidity, both on and off balance sheet.

BALANCE SHEET ANALYSIS

Securities

The securities portfolio generates income, plays a strategic role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The securities portfolio consists of high quality investments, mostly federal agency, mortgage-backed, and state and municipal securities.

The Company is cognizant of the continuing historically low and recently volatile interest rate environment and has elected to maintain a defensive asset liability strategy of purchasing high quality taxable securities of relatively short duration and somewhat longer term tax exempt securities, whose market values are not as volatile in rising rate environments as similar termed taxable investments. The Company is aware that possible changes in corporate tax rates could have a negative impact on our municipal portfolio valuation.

The following table presents information on the amortized cost, maturities, and taxable equivalent yields of securities at the end of the last three years (dollars in thousands):

	As of December 31,					
	2016		2015		2014	
	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield
Federal Agencies:						
Within 1 year	\$9,392	1.16 %	\$10,027	0.56 %	\$1,004	1.44 %
1 to 5 years	27,039	1.39	34,105	1.37	56,195	1.05
5 to 10 years	57,467	1.97	29,958	2.05	19,718	1.72
Over 10 years	12,481	2.02	7,511	2.70	5,041	2.63
Total	106,379	1.76	81,601	1.64	81,958	1.32
Mortgage-backed:						
Within 1 year	1,919	4.57	—	—	—	—
1 to 5 years	4,040	2.67	6,442	3.40	3,471	4.18
5 to 10 years	15,242	2.29	15,841	2.44	17,567	2.42
Over 10 years	58,716	1.99	48,237	2.12	35,251	2.39
Total	79,917	2.15	70,520	2.51	56,289	2.51
State and Municipal:						
Within 1 year	11,637	2.80	17,769	2.46	10,673	2.07
1 to 5 years	73,558	3.26	77,385	3.28	76,279	2.94
5 to 10 years	47,977	3.76	59,031	3.97	80,468	4.23
Over 10 years	12,585	3.36	16,083	3.87	20,640	3.97
Total	145,757	3.39	170,268	3.56	188,060	3.56
Corporate Securities:						
Within 1 year	2,313	1.72	249,00	0.92	—	—
1 to 5 years	4,279	1.85	7,914	1.81	7,916	1.83
5 to 10 years	500	2.42	2,456	3	500	2
Over 10 years	6,300	5.41	—	—	—	—
Total	13,392	3.53	10,619	2.08	8,416	1.86
Preferred Stock:						
No maturity	—	—	1,000	6.00	1,000	6.00
Total	—	—	1,000	6.00	1,000	6.00
Common Stock:						
No maturity	1,288	—	—	—	—	—
Total	1,288	—	—	—	—	—
Total portfolio	\$346,733	2.60 %	\$334,008	2.75 %	\$335,723	2.80 %

During 2016, the Company's investment in preferred stock was converted to common stock. At December 31, 2016, the Company had two common stock investments, neither of which was paying dividends, with a total amortized cost of \$1,288,000.

Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans.

Average loans increased \$87,417,000 or 9.0% from 2015 to 2016. Average loans increased \$171,001,000 or 21.2% from 2014 to 2015, mostly impacted by the MainStreet merger.

At December 31, 2016, total loans were \$1,164,821,000, an increase of \$159,296,000 or 15.8% from the prior year. The increase is the result of broad based organic loan growth and the de novo branch start-ups in Roanoke, Virginia and Winston-Salem, North Carolina.

Loans held for sale totaled \$5,996,000 at December 31, 2016 and \$3,266,000 at December 31, 2015. Loan production volume was \$78,330,000 and \$59,030,000 for 2016 and 2015, respectively. These loans were approximately 60% purchase, 40% refinancing.

Management of the loan portfolio is organized around portfolio segments. Each segment is comprised of various loan types that are reflective of operational and regulatory reporting requirements. The following table presents the Company's portfolio as of the dates indicated by segment (dollars in thousands):

Loans

	As of December 31,				
	2016	2015	2014	2013	2012
Real estate:					
Construction and land development	\$ 114,258	\$ 72,968	\$ 50,863	\$ 41,822	\$ 48,812
Commercial real estate	510,960	430,186	391,472	364,616	355,433
Residential real estate	215,104	220,434	175,293	171,917	161,033
Home equity	110,751	98,449	91,075	87,797	91,313
Total real estate	951,073	822,037	708,703	666,152	656,591
Commercial and industrial	208,717	177,481	126,981	122,553	126,192
Consumer	5,031	6,007	5,241	5,966	5,922

Total loans \$1,164,821 \$1,005,525 \$840,925 \$794,671 \$788,705

The following table provides loan balance information by geographic regions. In some circumstances, loans may be originated in one region for borrowers located in other regions (dollars in thousands):

Loans by Geographic Region

	As of December 31,		Percentage	
	2016		Change	
	Balance	Percentage of Portfolio	in Balance Since December 31, 2015	
Danville region	\$227,392	19.5 %	10.3 %	
Central region	150,432	12.9	(4.6)	
Southside region	84,486	7.3	4.3	
Eastern region	87,029	7.5	12.0	
Franklin region	111,162	9.5	(8.7)	
Roanoke region	41,142	3.5	N/A	
Alamance region	230,391	19.8	7.2	
Guilford region	227,988	19.6	55.6	
Winston-Salem region	4,799	0.4	N/A	

Total loans \$1,164,821 100.0 % 15.8 %

The large year over year increase in the Guilford region was the result of a convergence of improving business conditions in the Greensboro, North Carolina market and an ongoing, active program of customer outreach conducted by the Bank's market area lenders.

The Danville region consists of offices in Danville, Virginia and Yanceyville, North Carolina. The Central region consists of offices in Bedford, Lynchburg, and the counties of Bedford, Campbell, and Nelson, Virginia. The Southside region consists of offices in Martinsville and Henry County, Virginia. The Eastern region consists of offices in South Boston and the counties of Halifax and Pittsylvania, Virginia. The Franklin region consists of offices

in Rocky Mount, Union Hall, and Hardy, Virginia. The Roanoke region consists of an office in Roanoke County, Virginia. The Alamance region consists of offices in Burlington, Graham, and Mebane, North Carolina. The Guilford region consists of offices in Greensboro, North Carolina. The Winston-Salem region consists of an office in Winston-Salem, North Carolina.

The Company does not participate in or have any highly leveraged lending transactions, as defined by bank regulations. The Company has no foreign loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2016 or 2015, loans to lessors of nonresidential buildings represented 18.9% of total loans at December 31, 2016 and 19.5% at December 31, 2015. These lessees and lessors are engaged in a variety of industries.

The following table presents the maturity schedule of selected loan types (dollars in thousands):

Maturities of Selected Loan Types

December 31, 2016

	Commercial and Industrial (1)	Construction and Land Development	Total
1 year or less	\$ 47,940	\$ 26,657	\$ 74,597
1 to 5 years (2)	111,506	56,134	167,640
After 5 years (2)	49,271	31,467	80,738
Total	\$ 208,717	\$ 114,258	\$ 322,975

(1) Includes agricultural loans.

(2) Of the loans due after one year, \$147,520 have predetermined interest rates and \$100,858 have floating or adjustable interest rates.

Provision for Loan Losses

The provision for loan losses was \$250,000, \$950,000, and \$400,000 for the years ended December 31, 2016, 2015, and 2014, respectively.

The smaller provision expense in 2016 related to improvement in various qualitative factors, notably asset quality, local economic conditions and continued decline in historical loss factors. Improvements in asset quality were apparent in declines in past due and nonaccrual loans, as well as, in qualitative factors for asset quality and economic conditions, which were somewhat offset by additional factors assigned to unseasoned loans in new markets. The larger provision expense in 2015 related to the increase in organic loan growth and the relatively rapid maturities and renewals of the performing acquired loan portfolio of MainStreet and their resulting transfer to the regular loan portfolio.

Allowance for Loan Losses

The purpose of the ALLL is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The ALLL was \$12,801,000, \$12,601,000, and \$12,427,000 at December 31, 2016, 2015, and 2014, respectively.

The ALLL as a percentage of loans at each of those dates were 1.10%, 1.25%, and 1.48%, respectively.

The decrease in the allowance as a percentage of loans during 2016 was primarily due to continued high asset quality, low charge offs, and improvement in various qualitative factors, notably economic and legal, used in the determination of the allowance. The decrease in the allowance as a percentage of loans during 2015 was primarily impacted by the January 2015 acquisition of MainStreet.

In an effort to better evaluate the adequacy of its ALLL, the Company computes its ASC 450, Contingencies, loan balance by reducing total loans by acquired loans and loans that were evaluated for impairment individually or smaller balance nonaccrual loans evaluated for impairment in homogeneous pools. It also adjusts its ASC 450 loan loss reserve balance total by removing allowances associated with these other pools of loans.

The general allowance, ASC 450 (FAS 5) reserves to ASC 450 loans, was 1.17% at December 31, 2016, compared to 1.40% at December 31, 2015. On a dollar basis, the reserve was \$12,429,000 at December 31, 2016, compared to \$12,159,000 at December 31, 2015. The percentage of the reserve to total loans has declined due to improving local and national economic conditions and continued improvement in asset quality metrics. This segment of the allowance represents by far the largest portion of the loan portfolio and the largest aggregate risk.

The specific allowance, ASC 310-40 (FAS 114) reserves to ASC 310-40 loans, was 0.47% at December 31, 2016, compared to 1.17% at December 31, 2015. On a dollar basis, the reserve was \$23,000 at December 31, 2016,

compared to \$35,000 at December 31, 2015. The decrease in the dollar amount of the reserve was related to changes in characteristics of

46

loans reviewed individually for impairment and charge-offs of specific reserves in 2016 that were recorded in the prior year. There is ongoing turnover in the composition of the impaired loan population, which increased \$137,000 over December 31, 2015.

The specific allowance does not include reserves related to acquired loans with deteriorated credit quality. This reserve was \$349,000 at December 31, 2016, compared to \$407,000 at December 31, 2015. This is the only portion of the reserve related to acquired loans. Cash flow expectations for these loans are reviewed on a quarterly basis and unfavorable changes in those estimates relative to the initial estimates can result in the need for specific loan loss provision.

The following table presents the Company's loan loss and recovery experience for the past five years (dollars in thousands):

Summary of Loan Loss Experience

	Year Ended December 31,				
	2016	2015	2014	2013	2012
Balance at beginning of period	\$12,601	\$12,427	\$12,600	\$12,118	\$10,529
Charge-offs:					
Construction and land development	—	20	—	—	202
Commercial real estate	10	462	510	164	370
Residential real estate	21	15	121	213	579
Home equity	66	308	137	156	115
Total real estate	97	805	768	533	1,266
Commercial and industrial	40	175	101	129	748
Consumer	189	220	95	175	72
Total charge-offs	326	1,200	964	837	2,086
Recoveries:					
Construction and land development	11	81	28	227	87
Commercial real estate	21	43	38	96	388
Residential real estate	53	121	126	179	252
Home equity	15	18	65	65	27
Total real estate	100	263	257	567	754
Commercial and industrial	40	32	51	335	707
Consumer	136	129	83	123	81
Total recoveries	276	424	391	1,025	1,542
Net charge-offs (recoveries)	50	776	573	(188)	544
Provision for loan losses	250	950	400	294	2,133
Balance at end of period	\$12,801	\$12,601	\$12,427	\$12,600	\$12,118

The following table summarizes the allocation of the allowance for loan losses by major portfolio segments for the past five years (dollars in thousands):

Allocation of Allowance for Loan Losses

	Year Ended December 31,									
	2016		2015		2014		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	\$2,095	16.4 %	\$2,065	17.4 %	\$1,818	15.1 %	\$1,810	15.4 %	\$1,450	16.0 %
Commercial real estate	7,355	57.4	6,930	50.0	6,814	52.6	6,819	51.1	6,822	51.2
Residential real estate	3,303	25.8	3,546	28.1	3,715	31.7	3,690	32.7	3,638	32.0
Consumer	48	0.4	60	0.5	80	0.6	99	0.8	208	0.8
Unallocated	—	—	—	—	—	—	182	—	—	—
Total	\$12,801	100.0%	\$12,601	100.0%	\$12,427	100.0%	\$12,600	100.0%	\$12,118	100.0%

% - represents the percentage of loans in each category to total loans.

Asset Quality Indicators

The following table provides certain qualitative indicators relevant to the Company's loan portfolio for the past five years.

Asset Quality Ratios

	As of or for the Years Ended December 31,									
	2016		2015		2014		2013		2012	
		%		%		%		%		%
Allowance to loans*	1.10	%	1.25	%	1.48	%	1.59	%	1.54	%
ASC 450/general allowance	1.17		1.40		1.55		1.75		1.98	
Net charge-offs (recoveries) to year-end allowance	0.39		6.16		4.61		(1.49)	)	4.49	
Net charge-offs (recoveries) to average loans	0.00		0.08		0.07		(0.02)	)	0.07	
Nonperforming assets to total assets*	0.29		0.48		0.46		0.65		0.90	
Nonperforming loans to loans*	0.30		0.52		0.49		0.64		0.67	
Provision to net charge-offs (recoveries)	500.00		122.42		69.81		(156.38)		392.10	
Provision to average loans	0.02		0.10		0.05		0.04		0.26	
Allowance to nonperforming loans*	360.39		242.09		302.21		248.47		227.95	

* - at year end.

Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued and accruing loans that are contractually past due 90 days or more. Nonperforming loans include loans originated and loans acquired.

Nonperforming loans to total loans were 0.30% at December 31, 2016 compared to 0.52% at December 31, 2015. The decrease in nonperforming loans during 2016 was \$1,653,000.

Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming assets represented 0.29% at December 31, 2016 compared to 0.48% of total assets at December 31, 2015.

In most cases, it is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. In some cases a loan in process of renewal may become 90 days past due. In these instances the loan may still be accruing because of a delayed renewal process in which the customer has not been billed. In accounting for acquired impaired loans, such loans are not classified as nonaccrual when they become 90 days past due. They are considered to be accruing because their interest income relates to the accretable yield and not to contractual interest payments.

Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The Company strictly adheres with this policy before restoring a loan to normal accrual status.

The following table presents the Company's nonperforming asset history, including acquired impaired loans as of the dates indicated (dollars in thousands):

Nonperforming Assets

	As of December 31,				
	2016	2015	2014	2013	2012
Nonaccrual loans:					
Real estate	\$2,928	\$5,022	\$4,111	\$5,060	\$5,261
Commercial	19	90	—	11	52
Agricultural	—	—	—	—	—
Consumer	18	2	1	—	3
Total nonaccrual loans	2,965	5,114	4,112	5,071	5,316
Loans past due 90 days and accruing interest:					
Real estate	587	84	—	—	—
Commercial	—	—	—	—	—
Agricultural	—	—	—	—	—
Consumer	—	7	—	—	—
Total past due loans	587	91	—	—	—
Total nonperforming loans	3,552	5,205	4,112	5,071	5,316
Other real estate owned, net	1,328	2,184	2,119	3,422	6,193
Total nonperforming assets	\$4,880	\$7,389	\$6,231	\$8,493	\$11,509

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The following table shows loans that were considered impaired, exclusive of acquired impaired loans, as of the dates indicated (dollars in thousands):

Impaired Loans

	As of December 31,				
	2016	2015	2014	2013	2012
Accruing	\$2,059	\$1,171	\$989	\$958	\$499
On nonaccrual status	2,785	3,536	3,548	5,071	2,548
Total impaired loans	\$4,844	\$4,707	\$4,537	\$6,029	\$3,047

Troubled Debt Restructurings ("TDRs")

TDRs exist whenever the Company makes a concession to a customer based on the customer's financial distress that would not have otherwise been made in the normal course of business.

There was \$2,670,000 in TDRs at December 31, 2016 compared to \$1,958,000 at December 31, 2015.

Other Real Estate Owned

Other real estate owned is carried on the consolidated balance sheets at \$1,328,000 and \$2,184,000 as of December 31, 2016 and 2015, respectively. Foreclosed assets are initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the ALLL at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals. The following table shows OREO as of the dates indicated (dollars in thousands):

	As of December 31,				
	2016	2015	2014	2013	2012
Construction and land development	\$ 139	\$ 886	\$ 1,577	\$ 1,683	\$ 3,290
Farmland	—	—	—	—	236
1-4 family residential	653	643	382	1,400	1,090
Multifamily (5 or more) residential	—	—	—	—	1,012
Commercial real estate	536	655	160	339	565
	\$1,328	\$2,184	\$2,119	\$3,422	\$6,193

Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer and commercial time deposits. Average deposits increased \$68,844,000 or 5.6% in 2016, after increasing \$179,669,000 or 17.1% in 2015. The increase in 2015 was primarily related to the MainStreet acquisition.

Period-end total deposits increased \$107,980,000 or 8.6% during 2016. The increase was primarily related to steady growth in core deposits, which is consistent with the Company's asset liability strategy. The Company has only a relatively small portion of its time deposits provided by wholesale sources. These include brokered time deposits, of which there were none at year end 2016, 2015, and 2014, and time deposits through the CDARS program, which at year end totaled \$23,445,000 for 2016, \$23,633,000 for 2015, and \$22,255,000 for 2014. Management considers the CDARS deposits the functional, though not regulatory, equivalent of core deposits, because they relate to balances derived from customers with long standing relationships with the Company.

Average deposits and rates for the years indicated (dollars in thousands):

Deposits

	Year Ended December 31,					
	2016		2015		2014	
	Average Balance	Rate	Average Balance	Rate	Average Balance	Rate
Noninterest bearing deposits	\$ 330,315	— %	\$ 297,483	— %	\$ 234,149	— %
Interest bearing accounts:						
NOW accounts	\$ 216,521	0.05 %	\$ 223,825	0.04 %	\$ 183,994	0.04 %
Money market	239,262	0.18	196,828	0.13	177,046	0.13
Savings	118,144	0.04	109,697	0.05	88,629	0.05
Time	396,801	1.14	404,366	1.09	368,712	1.17
Total interest bearing deposits	\$ 970,728	0.53 %	\$ 934,716	0.51 %	\$ 818,381	0.57 %
Average total deposits	\$ 1,301,043	0.40 %	\$ 1,232,199	0.39 %	\$ 1,052,530	0.44 %

Certificates of Deposit of \$100,000 or More

Certificates of deposit at December 31, 2016 in amounts of \$100,000 or more were classified by maturity as follows (dollars in thousands):

	December 31, 2016
3 months or less	\$ 50,256
Over 3 through 6 months	12,636
Over 6 through 12 months	29,221
Over 12 months	152,271
Total	\$ 244,384

Certificates of Deposit of \$250,000 or More

Certificates of deposit at December 31, 2016 in amounts of \$250,000 or more were classified by maturity as follows (dollars in thousands):

	December 31, 2016
3 months or less	\$ 18,704
Over 3 through 6 months	4,653
Over 6 through 12 months	12,391
Over 12 months	106,779
Total	\$ 142,527

Borrowed Funds

In addition to internal deposit generation, the Company also relies on borrowed funds as a supplemental source of funding. Borrowed funds consist of customer repurchase agreements, overnight borrowings from the FHLB and longer-term FHLB advances, and trust preferred capital notes. Customer repurchase agreements are borrowings collateralized by securities of the U.S. Government, its agencies, or Government Sponsored Enterprises ("GSEs") and generally mature daily. The Company considers these accounts to be a stable and low cost source of funds. The securities underlying these agreements remain under the Company's control. Refer to Notes 11 and 12 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K for a discussion of long-term debt. The following table presents information pertaining to the Company's short-term borrowed funds as of the dates indicated (dollars in thousands):

Short-Term Borrowings

	As of December 31,	
	2016	2015
Customer repurchase agreements	\$39,166	\$40,611
FHLB overnight borrowings	20,000	—
Total	\$59,166	\$40,611

Weighted interest rate	0.29	%	0.02	%
------------------------	------	---	------	---

Average for the year ended:

Outstanding	\$47,488	\$48,119
Interest rate	0.02	% 0.02 %

Maximum month-end outstanding	\$59,166	\$53,664
-------------------------------	----------	----------

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At December 31, 2016, the Bank's public deposits totaled \$207,740,000. The Company is legally required to provide collateral to secure the deposits that exceed the insurance coverage provided by the FDIC. This collateral

can be provided in the form of certain types of government agency bonds or letters of credit from the FHLB. At year-end 2016, the Company had \$130,000,000 in letters of credit with the FHLB outstanding to supplement collateral for such deposits.

Shareholders' Equity

The Company's goal with capital management is to be classified as "well capitalized" under regulatory capital ratios and to support growth, while generating acceptable returns on equity and paying a high rate of dividends.

Shareholders' equity was \$201,380,000 at December 31, 2016 and \$197,835,000 at December 31, 2015.

The Company declared and paid quarterly dividends totaling \$0.96 per share for 2016, \$0.93 per share for 2015, and \$0.92 per share for 2014. Cash dividends in 2016 totaled \$8,266,000 and represented a 50.7% payout of 2016 net income, compared to a 53.6% payout in 2015, and a 56.8% payout in 2014.

In July 2013, the FRB issued final rules that make technical changes to its capital rules to align them with the Basel III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. The final rules maintain the general structure of the prompt corrective action framework in effect at such time while incorporating certain increased minimum requirements. Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the prior requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.0% of total assets (unchanged from the prior requirement). These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain such minimum ratios plus a 2.5% "capital conservation buffer" (other than for the leverage ratio). The phase in of the capital conservation buffer requirement began on January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. Management believes the Company and the Bank will be compliant with the fully phased-in requirements when they become effective January 1, 2019.

The following table represents the major regulatory capital ratios for the Company as of the dates indicated:

	As of December 31,				
	2016	2015	2014	2013	2012
Risk-Based Capital Ratios:					
Common equity tier 1 capital ratio	11.77%	12.88%	NA	NA	NA
Tier 1 capital ratio	13.83%	15.23%	16.59%	16.88%	15.75%
Total capital ratio	14.81%	16.34%	17.86%	18.14%	17.00%

Leverage Capital Ratios:

Tier 1 leverage ratio	11.67%	12.05%	12.16%	11.81%	11.27%
-----------------------	--------	--------	--------	--------	--------

Management believes the Company and the Bank meet the requirements to be considered "well capitalized" for all regulatory capital ratios as of December 31, 2016 and 2015.

Stock Repurchase Programs

In years prior to 2014 the Company had, in the normal course of business, operated certain stock repurchase programs. Authority to repurchase shares under these programs had been expired for some time.

On April 17, 2014, the Company filed a Form 8-K with the SEC to announce the approval by its Board of Directors (the "Board") of a stock repurchase program. The program authorized the repurchase of up to 250,000 shares of the Company's common stock over a two year period. The share purchase limit was established at such number of shares equal to approximately 3% of the 7,900,000 common shares then outstanding at the time the Board approved the program.

On November 19, 2015, the Company filed a Form 8-K with the SEC to announce the approval by its Board of another stock repurchase program. The program authorizes the repurchase of up to 300,000 shares of the Company's common stock over a two year period. The share purchase limit was established at such number of shares equal to approximately 3.5% of the 8,622,000 common shares then outstanding at the time the Board approved the program.

During 2016, the Company repurchased 51,384 shares at an average cost of \$25.14 per share, for a total cost of \$1,292,000. In 2015, the Company repurchased 150,656 shares at an average cost of \$23.27 per share, for a total cost of \$3,506,000.

CONTRACTUAL OBLIGATIONS

The following items are contractual obligations of the Company as of December 31, 2016 (dollars in thousands):

	Payments Due By Period				
	Total	Under 1 Year	1-3 Years	3-5 Years	More than 5 years
Time deposits	\$378,855	\$160,219	\$89,170	\$124,759	\$4,707
Repurchase agreements	39,166	39,166	—	—	—
FHLB borrowings	29,980	20,000	9,980	—	—
Operating leases	1,755	878	806	49	22
Junior subordinated debt	27,724	—	—	—	27,724

OFF-BALANCE SHEET ACTIVITIES

The Company enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. Other than AMNB Statutory Trust I, formed in 2006 to issue trust preferred securities, and the MidCarolina Trust I and MidCarolina Trust II, the Company does not have any off-balance sheet subsidiaries. Refer to Note 12 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K for a discussion of junior subordinated debt. Off-balance sheet transactions were as follows as of the dates indicated (dollars in thousands):

Off-Balance Sheet Commitments	December 31,	
	2016	2015
Commitments to extend credit	\$345,803	\$301,360
Standby letters of credit	4,088	4,286
Mortgage loan rate-lock commitments	12,839	5,365

Total off-balance sheet transaction volume increased significantly due to the demand from the de novo branches in Roanoke, Virginia and Winston-Salem, North Carolina.

Commitments to extend credit to customers represent legally binding agreements with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future funding requirements. Standby letters of credit are conditional commitments issued by the Company guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements.

ITEM 7A – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

This information is incorporated herein by reference from Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-K.

ITEM 8 – FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Quarterly Financial Results

(in thousands, except per share amounts)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
2016					
Interest income	\$ 14,171	\$ 13,769	\$ 14,063	\$ 14,167	\$ 56,170
Interest expense	1,587	1,609	1,599	1,521	6,316
Net interest income	12,584	12,160	12,464	12,646	49,854
Provision for loan losses	50	50	100	50	250
Net interest income after provision for loan losses	12,534	12,110	12,364	12,596	49,604
Noninterest income	3,297	3,367	3,120	3,721	13,505
Noninterest expense	9,918	9,656	9,867	10,360	39,801
Income before income taxes	5,913	5,821	5,617	5,957	23,308
Income taxes	1,785	1,733	1,654	1,835	7,007
Net income	\$ 4,128	\$ 4,088	\$ 3,963	\$ 4,122	\$ 16,301
Per common share:					
Net income - basic	\$ 0.48	\$ 0.47	\$ 0.46	\$ 0.48	\$ 1.89
Net income - diluted	0.48	0.47	0.46	0.48	1.89
Cash dividends	0.24	0.24	0.24	0.24	0.96
2015	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Interest income	\$ 13,839	\$ 13,837	\$ 13,542	\$ 13,951	\$ 55,169
Interest expense	1,461	1,455	1,481	1,507	5,904
Net interest income	12,378	12,382	12,061	12,444	49,265
Provision for loan losses	600	100	—	250	950
Net interest income after provision for loan losses	11,778	12,282	12,061	12,194	48,315
Noninterest income	3,156	3,258	3,055	3,818	13,287
Noninterest expense	10,047	11,642	9,388	9,466	40,543
Income before income taxes	4,887	3,898	5,728	6,546	21,059
Income taxes	1,372	1,018	1,691	1,939	6,020
Net income	\$ 3,515	\$ 2,880	\$ 4,037	\$ 4,607	\$ 15,039
Per common share:					
Net income - basic	\$ 0.40	\$ 0.33	\$ 0.47	\$ 0.53	\$ 1.73
Net income - diluted	0.40	0.33	0.47	0.53	1.73
Cash dividends	0.23	0.23	0.23	0.24	0.93

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
American National Bankshares Inc.
Danville, Virginia

We have audited the accompanying consolidated balance sheets of American National Bankshares Inc. and Subsidiary (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American National Bankshares Inc. and Subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), American National Bankshares Inc. and Subsidiary's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 16, 2017 expressed an unqualified opinion on the effectiveness of American National Bankshares Inc. and Subsidiary's internal control over financial reporting.

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

Winchester, Virginia
March 16, 2017

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
American National Bankshares Inc.
Danville, Virginia

We have audited American National Bankshares Inc. and Subsidiary's (the Company) internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements

of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2016 of American National Bankshares Inc. and Subsidiary, and our report dated March 16, 2017 expressed an unqualified opinion.

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

Winchester, Virginia
March 16, 2017

American National Bankshares Inc.

Consolidated Balance Sheets

As of December 31, 2016 and 2015

(Dollars in thousands, except per share data)

ASSETS	2016	2015
Cash and due from banks	\$20,268	\$19,352
Interest-bearing deposits in other banks	32,939	75,985
Securities available for sale, at fair value	346,502	340,349
Restricted stock, at cost	6,224	5,312
Loans held for sale	5,996	3,266
Loans, net of unearned income	1,164,821	1,005,525
Less allowance for loan losses	(12,801)	(12,601)
Net loans	1,152,020	992,924
Premises and equipment, net	25,439	23,567
Other real estate owned, net of valuation allowance of \$192 in 2016 and \$329 in 2015	1,328	2,184
Goodwill	43,872	43,872
Core deposit intangibles, net	1,719	2,683
Bank owned life insurance	18,163	17,658
Accrued interest receivable and other assets	24,168	20,447
Total assets	\$1,678,638	\$1,547,599
LIABILITIES and SHAREHOLDERS' EQUITY		
Liabilities:		
Demand deposits -- noninterest bearing	\$378,600	\$322,442
Demand deposits -- interest bearing	209,430	227,030
Money market deposits	283,035	200,495
Savings deposits	120,720	115,383
Time deposits	378,855	397,310
Total deposits	1,370,640	1,262,660
Short-term borrowings:		
Customer repurchase agreements	39,166	40,611
Other short-term borrowings	20,000	—
Long-term borrowings	9,980	9,958
Junior subordinated debt	27,724	27,622
Accrued interest payable and other liabilities	9,748	8,913
Total liabilities	1,477,258	1,349,764
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	—	—
Common stock, \$1 par, 20,000,000 shares authorized 8,618,051 shares outstanding at December 31, 2016 and 8,622,007 shares outstanding at December 31, 2015	8,578	8,605
Capital in excess of par value	75,076	75,375
Retained earnings	119,600	111,565
Accumulated other comprehensive income (loss), net	(1,874)	2,290

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Total shareholders' equity	201,380	197,835
Total liabilities and shareholders' equity	\$1,678,638	\$1,547,599

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

58

American National Bankshares Inc.
Consolidated Statements of Income
For the Years Ended December 31, 2016, 2015, and 2014
(Dollars in thousands, except per share data)

	2016	2015	2014
Interest and Dividend Income:			
Interest and fees on loans	\$ 47,971	\$ 46,860	\$ 39,257
Interest on federal funds sold	—	6	—
Interest and dividends on securities:			
Taxable	4,454	4,072	3,775
Tax-exempt	3,135	3,681	3,971
Dividends	334	346	296
Other interest income	276	204	156
Total interest and dividend income	56,170	55,169	47,455
Interest Expense:			
Interest on deposits	5,103	4,811	4,654
Interest on short-term borrowings	10	9	9
Interest on long-term borrowings	325	324	325
Interest on junior subordinated debt	878	760	742
Total interest expense	6,316	5,904	5,730
Net Interest Income	49,854	49,265	41,725
Provision for Loan Losses	250	950	400
Net Interest Income after Provision for Loan Losses	49,604	48,315	41,325
Noninterest Income:			
Trust fees	3,791	3,935	4,196
Service charges on deposit accounts	2,048	2,066	1,735
Other fees and commissions	2,680	2,377	1,903
Mortgage banking income	1,713	1,320	1,126
Securities gains, net	836	867	505
Brokerage fees	843	946	643
Income from Small Business Investment Companies	463	912	176
Other	1,131	864	892
Total noninterest income	13,505	13,287	11,176
Noninterest Expense:			
Salaries	17,568	16,554	14,688
Employee benefits	4,264	4,311	2,988
Occupancy and equipment	4,246	4,425	3,727
FDIC assessment	647	750	647
Bank franchise tax	995	898	901
Core deposit intangible amortization	964	1,201	1,114
Data processing	1,828	1,725	1,448
Software	1,143	1,158	1,019
Other real estate owned, net	336	99	240
Merger related expenses	—	1,998	780
Other	7,810	7,424	7,006
Total noninterest expense	39,801	40,543	34,558
Income Before Income Taxes	23,308	21,059	17,943
Income Taxes	7,007	6,020	5,202
Net Income	\$ 16,301	\$ 15,039	\$ 12,741
Net Income Per Common Share:			

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Basic	\$ 1.89	\$ 1.73	\$ 1.62
Diluted	\$ 1.89	\$ 1.73	\$ 1.62
Average Common Shares Outstanding:			
Basic	8,611,507	8,680,502	7,867,198
Diluted	8,621,241	8,688,450	7,877,576

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

American National Bankshares Inc.
 Consolidated Statements of Comprehensive Income
 For the Years Ended December 31, 2016, 2015, and 2014
 (Dollars in thousands)

	Year Ended December 31,		
	2016	2015	2014
Net income	\$16,301	\$15,039	\$12,741
Other comprehensive income (loss):			
Unrealized gains (losses) on securities available for sale	(5,736)	(1,785)	3,993
Tax effect	2,007	626	(1,398)
Reclassification adjustment for realized gains on securities	(836)	(867)	(505)
Tax effect	293	303	177
Change in unfunded pension liability	166	538	(1,728)
Tax effect	(58)	(189)	605
Other comprehensive income (loss)	(4,164)	(1,374)	1,144
Comprehensive income	\$12,137	\$13,665	\$13,885

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

American National Bankshares Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2016, 2015, and 2014

(Dollars in thousands except per share data)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2013	\$ 7,891	\$ 58,050	\$ 99,090	\$ 2,520	\$ 167,551
Net income	—	—	12,741	—	12,741
Other comprehensive income	—	—	—	1,144	1,144
Stock repurchased (70,184 shares)	(70)	(1,438)	—	—	(1,508)
Stock options exercised (26,000 shares)	26	416	—	—	442
Equity based compensation (25,849 shares)	25	622	—	—	647
Cash dividends paid, \$0.92 per share	—	—	(7,237)	—	(7,237)
Balance, December 31, 2014	7,872	57,650	104,594	3,664	173,780
Net income	—	—	15,039	—	15,039
Other comprehensive loss	—	—	—	(1,374)	(1,374)
Issuance of common stock (825,586 shares)	826	19,657	—	—	20,483
Stock repurchased (150,656 shares)	(151)	(3,355)	—	—	(3,506)
Stock options exercised (42,680 shares)	43	746	—	—	789
Equity based compensation (15,386 shares)	15	677	—	—	692
Cash dividends paid, \$0.93 per share	—	—	(8,068)	—	(8,068)
Balance, December 31, 2015	8,605	75,375	111,565	2,290	197,835
Net income	—	—	16,301	—	16,301
Other comprehensive loss	—	—	—	(4,164)	(4,164)
Stock repurchased (51,384 shares)	(51)	(1,241)	—	—	(1,292)
Stock options exercised (5,784 shares)	6	136	—	—	142
Vesting of restricted stock	5	(5)	—	—	—
Equity based compensation (41,644 shares)	13	811	—	—	824
Cash dividends paid, \$0.96 per share	—	—	(8,266)	—	(8,266)
Balance, December 31, 2016	\$ 8,578	\$ 75,076	\$ 119,600	\$ (1,874)	\$ 201,380

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

American National Bankshares Inc.
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2016, 2015, and 2014
(Dollars in thousands)

	2016	2015	2014
Cash Flows from Operating Activities:			
Net income	\$16,301	\$15,039	\$12,741
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	250	950	400
Depreciation	1,892	1,833	1,688
Net accretion of acquisition accounting adjustments	(2,318)	(3,197)	(2,431)
Core deposit intangible amortization	964	1,201	1,114
Net amortization of securities	2,678	2,720	2,535
Net gain on sale or call of securities	(836)	(867)	(505)
Gain on sale of loans held for sale	(1,328)	(1,041)	(883)
Proceeds from sales of loans held for sale	76,928	57,421	52,592
Originations of loans held for sale	(78,330)	(59,030)	(49,565)
Net loss (gain) on other real estate owned	72	(185)	(66)
Valuation allowance on other real estate owned	156	86	68
Net loss on sale of premises and equipment	9	(11)	10
Equity-based compensation expense	824	692	647
Net change in bank owned life insurance	(505)	(510)	(447)
Deferred income tax expense	882	1,741	49
Net change in interest receivable	(967)	744	207
Net change in other assets	(1,390)	1,778	(2,057)
Net change in interest payable	(32)	16	(23)
Net change in other liabilities	867	(118)	524
Net cash provided by operating activities	16,117	19,262	16,598
Cash Flows from Investing Activities:			
Proceeds from sales of securities available for sale	13,019	15,425	13,667
Proceeds from maturities, calls and paydowns of securities available for sale	140,483	122,984	78,350
Purchases of securities available for sale	(168,069)	(120,040)	(89,151)
Net change in restricted stock	(912)	(358)	355
Net increase in loans	(157,198)	(48,318)	(44,658)
Proceeds from sale of premises and equipment	1	44	—
Purchases of premises and equipment	(3,613)	(1,474)	(1,049)
Proceeds from sales of other real estate owned	923	2,135	1,687
Cash paid in bank acquisition	—	(5,935)	—
Cash acquired in bank acquisition	—	18,173	—
Net cash used in investing activities	(175,366)	(17,364)	(40,799)
Cash Flows from Financing Activities:			
Net change in demand, money market, and savings deposits	126,435	70,879	43,943
Net change in time deposits	(18,455)	(21,089)	(25,781)
Net change in customer repurchase agreements	(1,445)	(12,869)	14,002
Net change in other short-term borrowings	20,000	—	—
Net change in long-term borrowings	—	—	(38)
Common stock dividends paid	(8,266)	(8,068)	(7,237)

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Repurchase of common stock	(1,292)	(3,506)	(1,508)
Proceeds from exercise of stock options	142	789	442
Net cash provided by financing activities	117,119	26,136	23,823
Net Increase (Decrease) in Cash and Cash Equivalents	(42,130)	28,034	(378)
Cash and Cash Equivalents at Beginning of Period	95,337	67,303	67,681
Cash and Cash Equivalents at End of Period	\$53,207	\$95,337	\$67,303

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

American National Bankshares Inc.
Notes to Consolidated Financial Statements
December 31, 2016, 2015, and 2014

Note 1 – Summary of Significant Accounting Policies

Nature of Operations and Consolidation

The consolidated financial statements include the accounts of American National Bankshares Inc. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). The Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, goodwill and intangible assets, unfunded pension liability, other-than-temporary impairment of securities, accounting for merger and acquisition activity, accounting for acquired loans with specific credit-related deterioration, the valuation of other real estate owned, and the valuation of deferred tax assets and liabilities.

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the "AMNB Trust") and an unconsolidated wholly owned subsidiary of the Company, was formed for the purpose of issuing preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation ("Community First") which occurred in April 2006.

On July 1, 2011, the Company completed its acquisition of MidCarolina Financial Corporation ("MidCarolina") pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated December 15, 2010, between the Company and MidCarolina. MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank. The transaction has expanded the Company's footprint in North Carolina, adding eight branches in Alamance and Guilford Counties.

In July 2011, and in connection with its acquisition of MidCarolina Financial Corporation, the Company assumed liabilities of the MidCarolina Trust I and MidCarolina Trust II, two separate unconsolidated Delaware statutory trusts (the "MidCarolina Trusts"), which were also formed for the purpose of issuing preferred securities. Refer to Note 12 for further details concerning these entities.

On January 1, 2015, the Company completed its acquisition of MainStreet BankShares, Inc. ("MainStreet") pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between the Company and MainStreet (the "MainStreet Merger Agreement"). Immediately after the merger of MainStreet into the Company, Franklin Community Bank, N.A., MainStreet's wholly-owned bank subsidiary ("Franklin Bank"), merged with and into the Bank. Franklin Bank provided banking services to its customers from three banking offices located in Rocky Mount, Hardy, and Union Hall, Virginia. Refer to Note 2 for further details on the merger.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the AMNB Trust and the MidCarolina Trusts, as detailed in Note 12.

Cash and Cash Equivalents

Cash includes cash on hand, cash with correspondent banks, and cash on deposit at the Federal Reserve Bank of Richmond. Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less and are subject to an insignificant risk of change in value. Cash and cash equivalents are carried at cost.

Interest-bearing Deposits in Other Banks

Interest-bearing deposits in other banks mature within one year and are carried at cost.

Securities

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

The Company does not currently have any securities in held to maturity or trading and has no plans to add any to either category. Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Due to the nature and restrictions placed on the Company's investment in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank of Richmond, these securities have been classified as restricted equity securities and carried at cost.

Loans Held for Sale

Secondary market mortgage loans are designated as held for sale at the time of their origination. These loans are pre-sold with servicing released and the Company does not retain any interest after the loans are sold. These loans consist primarily of fixed-rate, single-family residential mortgage loans which meet the underwriting characteristics of certain government-sponsored enterprises (conforming loans). In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be committed, thus limiting interest rate risk. Loans held for sale are carried at fair value. Gains on sales of loans are recognized at the loan closing date and are included in noninterest income.

Derivative Loan Commitments

The Company enters into mortgage loan commitments whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheets with net changes in their fair values recorded in other expenses. Derivative loan commitments resulted in no income or loss for 2016, 2015 or 2014.

The period of time between issuance of a loan commitment and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery contracts, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed the interest rate risk on the loan. As a result, the Company is not generally exposed to significant losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The fair value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the estimated value of the underlying assets while taking into consideration the probability that the loan will be funded.

Loans

The Company makes mortgage, commercial, and consumer loans. A substantial portion of the loan portfolio is secured by real estate. The ability of the Company's debtors to honor their contracts is dependent upon the real estate market and general economic conditions in the Company's market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off, generally are reported at their outstanding unpaid principal balance adjusted for the allowance for loan losses, and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. The accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off when the loan is 120 days past due, unless secured and in process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

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

A loan is considered past due when a payment of principal or interest or both is due but not paid. Management closely monitors past due loans in timeframes of 30-59 days, 60-89 days, and 90 or more days past due.

These policies apply to all loan portfolio classes and segments.

Substandard and doubtful risk graded commercial, commercial real estate, and construction loans equal to or greater than \$100,000 are reviewed for impairment. All troubled debt restructurings, regardless of dollar amount, are also evaluated for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment and establishing a specific allowance include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Generally, large groups of smaller balance homogeneous loans (residential real estate and consumer loans) are collectively evaluated for impairment. The Company's policy for recognizing interest income on impaired loans is consistent with its nonaccrual policy.

The Company's loan portfolio is organized by major segment. These include: commercial, commercial real estate, residential real estate and consumer loans. Each segment has particular risk characteristics that are specific to the borrower and the generic category of credit. Commercial loan repayments are highly dependent on cash flows associated with the underlying business and its profitability. They can also be impacted by changes in collateral values. Commercial real estate loans share the same general risk characteristics as commercial loans, but are often more dependent on the value of the underlying real estate collateral and, when construction is involved, the ultimate completion of and sale of the project. Residential real estate loans are generally dependent on the value of collateral and the credit worthiness of the underlying borrower. Consumer loans are very similar in risk characteristics to residential real estate.

In connection with the MidCarolina and MainStreet mergers, certain loans were acquired which exhibited deteriorated credit quality since origination and for which the Company does not expect to collect all contractual payments. These purchased credit impaired loans are recorded at the amount paid, such that there is no carryover of the seller's allowance for loan losses. After acquisition, losses are recognized by an increase in the allowance for loan losses. Such purchased credit impaired loans are accounted for individually or aggregated into pools of loans based on common risk characteristics such as, credit score, loan type, and date of origination. The Company estimates the amount and timing of expected cash flows for each loan or pool, and the expected cash flows in excess of amount paid is recorded as interest income over the remaining life of the loan or pool (accretable yield). The excess of the loan's or pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference).

Over the life of the loan or pool, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, a loss is recorded as a provision for loan losses. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDRs"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. The Company has \$2,670,000 in loans classified as TDRs as of December 31, 2016 and \$1,958,000 as of December 31, 2015.

Allowance for Loan Losses

The purpose of the allowance for loan losses ("ALLL") is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The goal of the Company is to maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and the provision for loan loss expense.

The Company uses certain practices to manage its credit risk. These practices include (1) appropriate lending limits for loan officers, (2) a loan approval process, (3) careful underwriting of loan requests, including analysis of borrowers, cash flows, collateral, and market risks, (4) regular monitoring of the portfolio, including diversification by type and geography, (5) review of loans by the Loan Review department, which operates independently of loan production (the Loan Review function consists of a co-sourced arrangement using both internal personnel and external vendors to provide the Company with a more robust review function of the loan portfolio), (6) regular meetings of the Credit Committees to discuss portfolio and policy changes and make decisions on large or unusual loan requests, and (7) regular meetings of the Asset Quality Committee which reviews the status of individual loans.

Risk grades are assigned as part of the loan origination process. From time to time risk grades may be modified as warranted by the facts and circumstances surrounding the credit.

Calculation and analysis of the allowance for loan losses is prepared quarterly by the Finance Department. The Company's Credit Committee, Capital Management Committee, Audit Committee, and the Board of Directors review the allowance for adequacy.

The Company's allowance for loan losses has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates and judgments.

The formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, and portfolio concentrations. In the formula allowance for commercial and commercial real estate loans, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. Allowance calculations for consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category.

The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. These include:

- The present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan);
- The loan's observable market price, or
- The fair value of the collateral, net of estimated costs to dispose, if the loan is collateral dependent.

The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates. No single statistic, formula, or measurement determines the adequacy of the allowance. Management makes subjective and complex judgments about matters that are inherently uncertain, and different amounts would be

reported under different conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific

loan categories and specific loans. However, the entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified losses.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period as facts and circumstances evolve. Furthermore, management cannot provide assurance that in any particular period the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time.

Premises and Equipment

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

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

Goodwill and Intangible Assets

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Intangible assets related to branch transactions continued to amortize. The cost of purchased deposit relationships and other intangible assets, based on independent valuation, are being amortized over their estimated lives ranging from eight to ten years. The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified during the years ended December 31, 2016, 2015, and 2014.

Trust Assets

Securities and other property held by the trust and investment services segment in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Other Real Estate Owned

Other real estate owned represents real estate that has been acquired through loan foreclosures or deeds received in lieu of loan payments. Generally, such properties are appraised at the time acquired, and are recorded at fair value less estimated selling costs. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in noninterest expense.

Bank Owned Life Insurance

The Company has acquired bank owned life insurance ("BOLI") in connection with three acquisitions over the past decade. The asset is reflected as the cash surrender value of the policies as provided by the insurer on a monthly basis.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company – put presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Income Taxes

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

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company had no liability for unrecognized tax benefits as of December 31, 2016 and 2015.

Stock-Based Compensation

Stock compensation accounting guidance Accounting Standards Codification ("ASC 718"), "Compensation – Stock Compensation" requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards.

Earnings Per Common Share

Basic earnings per common share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflect the impact of additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company consist solely of outstanding stock options, and are determined using the treasury method. Nonvested shares of restricted stock are included in the computation of basic earning per share because the holder has voting rights and shares in non-forfeitable dividends during the vesting period.

Comprehensive Income

Comprehensive income is shown in a two statement approach, the first statement presents total net income and its components followed by a second statement that presents all the components of other comprehensive income such as unrealized gains and losses on available for sale securities and changes in the funded status of a defined benefit postretirement plan.

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred, and were \$260,000, \$356,000, and \$453,000 in 2016, 2015, and 2014, respectively.

Mergers and Acquisitions

Business combinations are accounted for under ASC 805, "Business Combinations", using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company relies on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. Under the acquisition method of accounting, the Company identifies the acquirer and the closing date and applies applicable recognition principles and conditions. Acquisition-related costs are costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of costs to the Company include systems conversions, integration planning consultants and advertising costs. The Company accounts for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities is recognized in accordance with other applicable GAAP. These acquisition-related costs have been and will be included within the Consolidated Statements of Income classified within the noninterest expense caption.

Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year. There were no material reclassifications.

Use of Estimates

In preparing consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, goodwill and intangible assets, unfunded pension liability, other-than-temporary impairment of securities, accounting for merger and acquisition activity, accounting for acquired loans with specific credit-related deterioration, the valuation of other real estate owned, and the valuation of deferred tax assets and liabilities.

Recent Accounting Pronouncements

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

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: (1) requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables); and (4) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this

ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured

on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

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

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

During March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting." The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (1) income tax consequences; (2) classification of awards as either equity or liabilities; and (3) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

During June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale

debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for Securities and Exchange Commission ("SEC") filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

During August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments", to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments

for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

During January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business". The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

During January 2017, the FASB issued ASU No. 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

Note 2 - Acquisition of MainStreet BankShares, Inc.

On January 1, 2015, the Company completed its acquisition of MainStreet. The merger of MainStreet with and into the Company was effected pursuant to the terms and conditions of the MainStreet Merger Agreement. Immediately after the merger, Franklin Bank, MainStreet's wholly owned bank subsidiary, merged with and into the Bank.

Pursuant to the MainStreet Merger Agreement, holders of shares of MainStreet common stock received \$3.46 in cash and 0.482 shares of the Company's common stock for each share of MainStreet common stock held immediately prior to the effective date of the merger, plus cash in lieu of fractional shares. Each option to purchase shares of MainStreet common stock that was outstanding immediately prior to the effective date of the merger vested upon the merger and was converted into an option to purchase shares of the Company's common stock, adjusted based on a 0.643 exchange ratio. Each share of the Company's common stock outstanding immediately prior to the merger remained outstanding and was unaffected by the merger. The cash portion of the merger consideration was funded through a cash dividend of \$6,000,000 from the Bank to the Company, and no borrowing was incurred by the Company or the Bank in connection with the merger. Replacement stock option awards representing 43,086 shares of the Company's common stock were granted in conjunction with the MainStreet acquisition.

	Amounts Previously Recognized as of September 30, 2015	Measurement Period Adjustments	Adjusted Amounts Recognized as of December 31, 2015
Consideration Paid:			
Common shares issued (825,586)	\$ 20,483	\$ —	\$ 20,483
Cash paid to Shareholders	5,935	—	5,935
Value of consideration	26,418	—	26,418
Assets acquired:			
Cash and cash equivalents	18,173	—	18,173
Investment securities	18,507	—	18,507
Restricted stock	587	—	587
Loans	115,237	(723)	115,960
Premises and equipment	956	—	956
Deferred income taxes	3,056	262	2,794
Core deposit intangible	1,839	—	1,839
Other real estate owned	168	—	168
Bank owned life insurance	1,955	—	1,955
Accrued interest receivable and other assets	1,049	—	1,049
Total assets	161,527	(461)	161,988
Liabilities assumed:			
Deposits	137,323	—	137,323
Accrued interest payable and other liabilities	3,076	—	3,076
Total liabilities	140,399	—	140,399
Net assets acquired	21,128	(461)	21,589
Goodwill resulting from merger with MainStreet	\$ 5,290		\$ 4,829

The Company accounted for the acquisition using the acquisition method of accounting in accordance with ASC 805, Business Combinations. Under the acquisition method of accounting, the assets and liabilities of MainStreet were recorded at their respective acquisition date fair values. Determining the fair value of assets and liabilities, particularly related to the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate the estimated fair values. The fair values determined on the acquisition date were preliminary and subject to refinement during the measurement period as additional information relative to the acquisition date fair values became available. Goodwill of \$5,300,000 was initially recorded at the time of the acquisition. The decrease in goodwill was made during the fourth quarter of 2015 was due to a revaluation of the loan portfolio. As part of management's revaluation process, information and payments received subsequent to the initial valuation provided evidence that the credit mark on certain purchase credit impaired loans was too large. Management determined that these conditions existed as of the date of acquisition, but the information was not readily available. The revaluation process resulted in a reduction of \$723,000 in the credit mark for acquired impaired loans and an increase in deferred taxes of \$262,000 for a net decrease in goodwill of \$461,000.

Note 3 – Restrictions on Cash

The Company is a member of the Federal Reserve System and is required to maintain certain levels of its cash and cash equivalents as reserves based on regulatory requirements. This reserve requirement was \$0 at December 31, 2016 and 2015.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2016 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$485,000.

Note 4 - Securities

The amortized cost and estimated fair value of investments in securities at December 31, 2016 and 2015 were as follows (dollars in thousands):

	December 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$ 106,379	\$ 62	\$ 2,387	\$ 104,054
Mortgage-backed and CMOs	79,917	514	938	79,493
State and municipal	145,757	2,540	782	147,515
Corporate	13,392	123	23	13,492
Equity securities	1,288	660	—	1,948
Total securities available for sale	\$ 346,733	\$ 3,899	\$ 4,130	\$ 346,502
	December 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$ 81,601	\$ 170	\$ 319	\$ 81,452
Mortgage-backed and CMOs	70,520	799	389	70,930
State and municipal	170,268	5,659	36	175,891
Corporate	10,619	28	57	10,590
Equity securities	1,000	486	—	1,486
Total securities available for sale	\$ 334,008	\$ 7,142	\$ 801	\$ 340,349

The amortized cost and estimated fair value of investments in securities at December 31, 2016, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities have both known principal repayment terms as well as unknown principal repayments due to potential borrower pre-payments, it is difficult to accurately predict the final maturity of these investments. Mortgage-backed securities are shown separately (dollars in thousands):

	Available for Sale	
	Amortized Fair	
	Cost	Value
Due in one year or less	\$23,342	\$23,422
Due after one year through five years	104,876	106,028
Due after five years through ten years	105,944	104,973
Due after ten years	31,366	30,639
Mortgage-backed and CMOs	79,917	79,492
Equity securities	1,288	1,948
	\$346,733	\$346,502

Gross realized gains and losses from the sale of securities available for sale were as follows (dollars in thousands):

	For the Years Ended		
	December 31,		
	2016	2015	2014
Realized gains	\$844	\$871	\$507
Realized losses	(8)	(4)	(2)
Other-than-temporary impairment	—	—	—

Securities with a carrying value of approximately \$202,577,000 and \$173,146,000 at December 31, 2016 and 2015, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law. FHLB letters of credit were used as additional collateral in the amounts of \$130,700,000 at December 31, 2016 and \$70,700,000 at December 31, 2015.

Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2016. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period. Available for sale securities that have been in a continuous unrealized loss position are as follows (dollars in thousands):

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$89,597	\$ 2,387	\$89,597	\$ 2,387	\$—	\$ —
Mortgage-backed and CMOs	57,762	938	56,076	911	1,686	27
State and municipal	47,221	782	47,221	782	—	—
Corporate	2,895	23	2,895	23	—	—
Total	\$197,475	\$ 4,130	\$195,789	\$ 4,103	\$1,686	\$ 27

Federal agencies and GSEs: The unrealized losses on the Company's investment in 21 government sponsored entities ("GSE") were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

Mortgage-backed securities: The unrealized losses on the Company's investment in 37 GSE mortgage-backed securities were caused by interest rate increases. Three of these securities were in an unrealized loss position for 12 months or more. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

Collateralized Mortgage Obligations: The unrealized loss associated with one private GSE collateralized mortgage obligation ("CMO") is due to normal market fluctuations. This security has been in an unrealized loss position for 12 months or more. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

State and municipal securities: The unrealized losses on 64 state and municipal securities were caused by interest rate increases and not credit deterioration. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

Corporate securities: The unrealized losses on four corporate securities were caused by interest rate increases and not credit deterioration. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank and FHLB, these securities have been classified as restricted equity securities and carried at cost. These restricted securities are not subject to the investment security classifications and are included as a separate line item on the Company's Consolidated Balance Sheet. The FHLB requires the Bank to maintain stock in an amount equal to 4.5% of outstanding borrowings and a specific percentage of the Bank's total assets. The Federal Reserve Bank of Richmond requires the Bank to maintain stock with a par value equal to 3.0% of its outstanding capital and an additional 3.0% is on call. Restricted equity securities consist of Federal Reserve Bank stock in the amount of \$3,559,000 and \$3,535,000 as of December 31, 2016 and 2015 and FHLB stock in the amount of \$2,665,000 and \$1,777,000 as of December 31, 2016 and 2015, respectively.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2015 (dollars in thousands):

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$57,711	\$ 319	\$57,711	\$ 319	\$—	\$ —
Mortgage-backed and CMOs	37,368	389	35,424	346	1,944	43
State and municipal	13,540	36	12,716	34	824	2
Corporate	5,107	57	3,530	29	1,577	28

Total \$113,726 \$ 801 \$109,381 \$ 728 \$4,345 \$ 73

Other-Than-Temporary-Impaired Securities

As of December 31, 2016 and 2015, there were no securities classified as other-than-temporary impaired.

75

Note 5 – Loans

Loans, excluding loans held for sale, at December 31, 2016 and 2015 were comprised of the following (dollars in thousands):

	December 31,	
	2016	2015
Commercial	\$208,717	\$177,481
Commercial real estate:		
Construction and land development	114,258	72,968
Commercial real estate	510,960	430,186
Residential real estate:		
Residential	215,104	220,434
Home equity	110,751	98,449
Consumer	5,031	6,007
Total loans	\$1,164,821	\$1,005,525

Net deferred loan (fees) costs included in the above loan categories are \$(176,000) for 2016 and \$(575,000) for 2015. Overdraft deposits were reclassified to consumer loans in the amount of \$128,000 and \$82,000 for 2016 and 2015, respectively.

Acquired Loans

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at December 31, 2016 and 2015, are as follows (dollars in thousands):

	2016	2015
Outstanding principal balance	\$104,172	\$145,380
Carrying amount	96,487	135,254

The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies ASC 310-30 to account for interest earned, as of the indicated dates are as follows (dollars in thousands):

	December 31, December 31,	
	2016	2015
Outstanding principal balance	\$ 34,378	\$ 40,951
Carrying amount	28,669	33,885

The following table presents changes in the accretable yield on acquired impaired loans, for which the Company applies ASC 310-30, for the year ended December 31, 2016 (dollars in thousands):

	2016	2015	2014
Balance at January 1	\$7,299	\$1,440	\$2,046
Additions from merger with MainStreet	—	7,140	—
Accretion	(3,232)	(4,313)	(1,185)
Reclassification from nonaccretable difference	2,197	238	579
Other changes, net	(161)	2,794	—
Balance at December 31	\$6,103	\$7,299	\$1,440

Past Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2016 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$50	\$—	\$ —	\$ 19	\$69	\$208,648	\$208,717
Commercial real estate:							
Construction and land development	60	12	—	64	136	114,122	114,258
Commercial real estate	—	127	339	773	1,239	509,721	510,960
Residential:							
Residential	1,280	117	248	1,802	3,447	211,657	215,104
Home equity	229	—	—	289	518	110,233	110,751
Consumer	6	5	—	18	29	5,002	5,031
Total	\$1,625	\$261	\$ 587	\$2,965	\$5,438	\$1,159,383	\$1,164,821

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2015 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$137	\$—	\$ —	\$ 90	\$227	\$177,254	\$177,481
Commercial real estate:							
Construction and land development	—	—	—	258	258	72,710	72,968
Commercial real estate	135	182	—	2,497	2,814	427,372	430,186
Residential:							
Residential	913	398	84	1,647	3,042	217,392	220,434
Home equity	140	12	—	620	772	97,677	98,449
Consumer	53	1	7	2	63	5,944	6,007
Total	\$1,378	\$593	\$ 91	\$5,114	\$7,176	\$998,349	\$1,005,525

Impaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding acquired impaired loans, at December 31, 2016 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 24	\$ 24	\$ —	\$ 12	\$ 2
Commercial real estate:					
Construction and land development	158	157	—	198	16
Commercial real estate	1,916	1,917	—	1,409	107
Residential:					
Residential	557	567	—	318	38
Home equity	6	6	—	153	16
Consumer	9	9	—	10	1
	\$ 2,670	\$ 2,680	\$ —	\$ 2,100	\$ 180
With a related allowance recorded:					
Commercial*	\$ 19	\$ 19	\$ —	\$ 78	\$ 1
Commercial real estate:					
Construction and land development*	64	65	—	272	10
Commercial real estate*	48	48	—	286	7
Residential					
Residential	1,639	1,639	22	1,593	32
Home equity	386	385	1	345	4
Consumer*	18	18	—	14	—
	\$ 2,174	\$ 2,174	\$ 23	\$ 2,588	\$ 54
Total:					
Commercial	\$ 43	\$ 43	\$ —	\$ 90	\$ 3
Commercial real estate:					
Construction and land development	222	222	—	470	26
Commercial real estate	1,964	1,965	—	1,695	114
Residential:					
Residential	2,196	2,206	22	1,911	70
Home equity	392	391	1	498	20
Consumer	27	27	—	24	1
	\$ 4,844	\$ 4,854	\$ 23	\$ 4,688	\$ 234

*Allowance is reported as zero in the table due to presentation in thousands and rounding.

The following table presents the Company's impaired loan balances by portfolio segment, excluding acquired impaired loans, at December 31, 2015 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 4	\$ 4	\$ —	\$ 47	\$ —
Commercial real estate:					
Construction and land development	205	205	—	220	—
Commercial real estate	1,202	1,206	—	1,504	1
Residential:					
Residential	127	124	—	126	—
Home equity	173	173	—	305	—
Consumer	13	13	—	14	—
	\$ 1,724	\$ 1,725	\$ —	\$ 2,216	\$ 1
With a related allowance recorded:					
Commercial*	\$ 91	\$ 91	\$ —	\$ 99	\$ —
Commercial real estate:					
Construction and land development	448	449	6	563	26
Commercial real estate	390	391	3	353	17
Residential:					
Residential*	1,649	1,690	—	1,034	22
Home equity	397	396	25	327	—
Consumer	8	9	1	11	—
	\$ 2,983	\$ 3,026	\$ 35	\$ 2,387	\$ 65
Total:					
Commercial	\$ 95	\$ 95	\$ —	\$ 146	\$ —
Commercial real estate:					
Construction and land development	653	654	6	783	26
Commercial real estate	1,592	1,597	3	1,857	18
Residential:					
Residential	1,776	1,814	—	1,160	22
Home equity	570	569	25	632	—
Consumer	21	22	1	25	—
	\$ 4,707	\$ 4,751	\$ 35	\$ 4,603	\$ 66

*Allowance is reported as zero in the table due to presentation in thousands and rounding.

The following table shows the detail of loans modified as TDRs during the year ended December 31, 2016, 2015, and 2014, included in the impaired loan balances (dollars in thousands):

	Loans Modified as a TDR for the Year Ended December 31, 2016	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	2 \$ 24	\$ 24
Commercial real estate	2 1,005	1,003
Equity	—	—
Residential real estate	4 322	312
Consumer	—	—
Total	8 \$ 1,351	\$ 1,339
	Loans Modified as a TDR for the Year Ended December 31, 2015	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	—\$ —	\$ —
Commercial real estate	3 394	394
Equity	1 107	105
Residential real estate	4 596	583
Consumer	—	—
Total	8 \$ 1,097	\$ 1,082
	Loans Modified as a TDR for the Year Ended December 31, 2014	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	—\$ —	\$ —
Commercial real estate	2 743	737
Equity	1 8	8
Residential real estate	2 121	124
Consumer	—	—
Total	5 \$ 872	\$ 869

During the years ended December 31, 2016, 2015, and 2014, the Company had no loans that subsequently defaulted within twelve months of modification. The Company defines default as one or more payments that occur more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

The following table summarizes the primary reason certain loan modifications were classified as TDRs and includes newly designated TDRs as well as modifications made to existing TDRs. Balances represent the recorded investment at the end of the year in which the modification was made. Rate modifications include TDRs made with below market interest rates that also include modifications of loan structures (dollars in thousands):

	Year Ended December 31,							
	2016		2015		2014			
	Type of Modification	ALLL	Type of Modification	ALLL	Type of Modification	ALLL	Type of Modification	ALLL
	Rate	Structure	Rate	Structure	Rate	Structure	Rate	Structure
Commercial	\$ —	\$ 24	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Commercial real estate	—	1,003	—	394	—	—	737	—
Equity	—	—	105	—	1	—	8	—
Residential real estate	—	312	1	583	19	—	124	1
Consumer	—	—	—	—	—	—	—	—
Total	\$ —	\$ 1,339	\$ 1	\$ 105	\$ 977	\$ 20	\$ —	\$ 869

The Company had \$325,000 in residential real estate loans in the process of foreclosure at December 31, 2016 and \$653,000 and \$643,000 in residential OREO at December 31, 2016 and December 31, 2015, respectively.

Risk Ratings

The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2016 (dollars in thousands):

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

	Commercial	Construction and Land Development	Commercial Estate	Residential Real Estate	Home Equity
Pass	\$ 208,098	\$ 112,729	\$ 501,081	\$ 199,278	\$ 108,799
Special Mention	592	902	4,859	10,600	1,257
Substandard	27	627	5,020	5,226	695
Doubtful	—	—	—	—	—
Total	\$ 208,717	\$ 114,258	\$ 510,960	\$ 215,104	\$ 110,751

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

	Consumer
Performing	\$ 5,003
Nonperforming	28
Total	\$ 5,031

Loans classified in the Pass category typically are fundamentally sound and risk factors are reasonable and acceptable.

Loans classified in the Special Mention category typically have been criticized internally, by loan review or the loan officer, or by external regulators under the current credit policy regarding risk grades.

Loans classified in the Substandard category typically have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are typically characterized by the possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Loans classified in the Doubtful category typically have all the weaknesses inherent in loans classified as substandard, plus the added characteristic the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions,

and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur that may salvage the debt.

Consumer loans are classified as performing or nonperforming. A loan is nonperforming when payments of interest and principal are past due 90 days or more, or payments are less than 90 days past due, but there are other good reasons to doubt that payment will be made in full.

The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2015 (dollars in thousands):

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

	Commercial	Construction and Land Development	Commercial Real Estate	Residential Real Estate	Home Equity
Pass	\$ 175,963	\$ 68,853	\$ 418,719	\$ 200,008	\$ 96,142
Special Mention	1,364	1,210	5,860	14,638	1,314
Substandard	154	2,905	5,607	5,788	993
Doubtful	—	—	—	—	—
Total	\$ 177,481	\$ 72,968	\$ 430,186	\$ 220,434	\$ 98,449

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

	Consumer
Performing	\$ 5,999
Nonperforming	8
Total	\$ 6,007

Note 6 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for each of the years in the three-year period ended December 31, 2016, are presented below (dollars in thousands):

	Years Ended December 31,		
	2016	2015	2014
Allowance for Loan Losses			
Balance, beginning of year	\$12,601	\$12,427	\$12,600
Provision for loan losses	250	950	400
Charge-offs	(326)	(1,200)	(964)
Recoveries	276	424	391
Balance, end of year	\$12,801	\$12,601	\$12,427

	Years Ended December 31,		
	2016	2015	2014
Reserve for Unfunded Lending Commitments			
Balance, beginning of year	\$184	\$163	\$210
Provision for (recovery) unfunded commitments	19	21	(47)
Charge-offs (recovery of)	—	—	—
Balance, end of year	\$203	\$184	\$163

The reserve for unfunded loan commitments is included in other liabilities, and the provision for (recovery of) unfunded commitments is included in noninterest expense. The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment for the year ended December 31, 2016 (dollars in thousands):

	Commercial	Commercial	Residential	Real	Unallocated	Total
		Estate	Estate	Consumer		
Allowance for Loan Losses						
Balance at December 31, 2015	\$ 2,065	\$ 6,930	\$ 3,546	\$ 60	\$	—\$12,601
Charge-offs	(40	) (10	) (87	) (189	) —	(326
Recoveries	40	32	68	136	—	276
Provision	30	403	(224	) 41	—	250
Balance at December 31, 2016	\$ 2,095	\$ 7,355	\$ 3,303	\$ 48	\$	—\$12,801

Balance at December 31, 2016:

Allowance for Loan Losses						
Individually evaluated for impairment	\$ —	\$ —	\$ 23	\$ —	\$	—\$23
Collectively evaluated for impairment	2,087	7,248	3,046	48	—	12,429
Acquired impaired loans	8	107	234	—	—	349
Total	\$ 2,095	\$ 7,355	\$ 3,303	\$ 48	\$	—\$12,801

Loans

Individually evaluated for impairment	\$ 43	\$ 2,186	\$ 2,588	\$ 27	\$	—\$4,844
Collectively evaluated for impairment	208,258	610,462	307,600	4,988	—	1,131,308
Acquired impaired loans	416	12,570	15,667	16	—	28,669
Total	\$ 208,717	\$ 625,218	\$ 325,855	\$ 5,031	\$	—\$1,164,821

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment for the year ended December 31, 2015 (dollars in thousands):

	Commercial	Commercial Estate	Residential Estate	Real Consumer	Unallocated	Total
Allowance for Loan Losses						
Balance at December 31, 2014	\$ 1,818	\$ 6,814	\$ 3,715	\$ 80	\$ —	—\$12,427
Charge-offs	(175)	(482)	(323)	(220)	—	(1,200)
Recoveries	32	124	139	129	—	424
Provision	390	474	15	71	—	950
Balance at December 31, 2015	\$ 2,065	\$ 6,930	\$ 3,546	\$ 60	\$ —	—\$12,601

Balance at December 31, 2015:

Allowance for Loan Losses						
Individually evaluated for impairment	\$ —	\$ 9	\$ 26	\$ —	\$ —	—\$35
Collectively evaluated for impairment	2,065	6,750	3,284	60	—	12,159
Acquired impaired loans	—	171	236	—	—	407
Total	\$ 2,065	\$ 6,930	\$ 3,546	\$ 60	\$ —	—\$12,601

Loans

Individually evaluated for impairment	\$ 95	\$ 2,245	\$ 2,346	\$ 21	\$ —	—\$4,707
Collectively evaluated for impairment	176,798	487,177	297,281	5,684	—	966,940
Acquired impaired loans	588	13,732	19,256	302	—	33,878
Total	\$ 177,481	\$ 503,154	\$ 318,883	\$ 6,007	\$ —	—\$1,005,525

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analysis of smaller balance, homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers, other lending staff and loan review; national, regional, and local economic trends and conditions; legal, regulatory and collateral factors; and concentrations of credit.

Note 7 – Premises and Equipment

Major classifications of premises and equipment at December 31, 2016 and 2015 are summarized as follows (dollars in thousands):

	December 31,	
	2016	2015
Land	\$6,891	\$6,077
Buildings	25,616	23,481
Leasehold improvements	1,078	1,399
Furniture and equipment	16,372	18,686
	49,957	49,643
Accumulated depreciation	(24,518)	(26,076)
Premises and equipment, net	\$25,439	\$23,567

Depreciation expense for the years ended December 31, 2016, 2015, and 2014 was \$1,892,000, \$1,833,000, and \$1,688,000, respectively.

The Company has entered into operating leases for several of its branch and ATM facilities. The minimum annual rental payments under these leases at December 31, 2016 are as follows (dollars in thousands):

Year	Minimum Lease Payments
2017	\$ 878
2018	650
2019	155
2020	36
2021	13
2022 and after	23
	\$ 1,755

Lease expense, a component of occupancy and equipment expense, for the years ended December 31, 2016, 2015, and 2014 was \$897,000, \$990,000, and \$657,000, respectively.

Note 8 – Goodwill and Other Intangible Assets

The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified during the years ended December 31, 2016, 2015, and 2014.

Core deposit intangibles resulting from the Community First acquisition in April 2006 were \$3,112,000 and were amortized over 99 months ending in 2015. Core deposit intangibles resulting from the MidCarolina acquisition in July 2011 were \$6,556,000 and are being amortized on an accelerated basis over 108 months. Core deposit intangibles resulting from the MainStreet acquisition were \$1,839,000 and are being amortized on an accelerated basis over 120 months.

The changes in the carrying amount of goodwill and intangibles for the twelve months ended December 31, 2016, are as follows (dollars in thousands):

	Goodwill	Intangibles
Balance at December 31, 2015	\$ 43,872	\$ 2,683
Amortization	—	(964)
Balance at December 31, 2016	\$ 43,872	\$ 1,719

Goodwill and intangible assets at December 31, 2016 and 2015 are as follow (dollars in thousands):

	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
December 31, 2016			
Core deposit intangibles	\$ 11,508	\$ (9,789)	\$ 1,719
Goodwill	43,872	—	43,872
December 31, 2015			
Core deposit intangibles	\$ 11,508	\$ (8,825)	\$ 2,683
Goodwill	43,872	—	43,872

Amortization expense of core deposit intangibles for the years ended December 31, 2016, 2015, and 2014 were \$964,000, \$1,201,000, and \$1,114,000, respectively. As of December 31, 2016, the estimated future amortization expense of core deposit intangibles is as follows (dollars in thousands):

Year	Amount
2017	\$ 528
2018	265
2019	219
2020	207
2021	197
2022 and after	303
Total	\$ 1,719

Note 9 - Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2016 and 2015 was \$142,527,000 and \$132,686,000, respectively.

At December 31, 2016, the scheduled maturities of certificates of deposits (included in "time" deposits on the Consolidated Balance Sheet) were as follows (dollars in thousands):

Year	Amount
2017	\$160,218
2018	57,268
2019	31,902
2020	30,640
2021	94,119
2022 and after	4,708
Total	\$378,855

There were no brokered time deposits at December 31, 2016 or December 31, 2015. Time deposits through the Certificate of Deposit Account Registry Service ("CDARS") program totaled \$23,445,000 at December 31, 2016 compared to \$23,633,000 at December 31, 2015. Deposits through the CDARS program are generated from major customers with substantial relationships to the Bank.

Note 10 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 each, and, additionally, has access to the Federal Reserve Bank of Richmond's discount window. Customer repurchase agreements are collateralized by securities of the U.S. Government, its agencies or GSEs. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted solely of the following at December 31, 2016 and 2015 (dollars in thousands):

	December 31, 2016		December 31, 2015	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate
Customer repurchase agreements	\$39,166	0.01 %	\$40,611	0.02 %
Other short-term borrowings	20,000	0.80 %	—	— %
	\$59,166		\$40,611	

Note 11 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of December 31, 2016, \$407,926,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings.

Long-term borrowings consisted of the following fixed rate, advances as of December 31, 2016 and 2015 (dollars in thousands):

2016			2015		
Due by	Advance Amount	Weighted Average Rate	Due by	Advance Amount	Weighted Average Rate
November 30, 2017	\$ 9,980	2.98 %	November 30, 2017	\$9,958	2.98 %

The advance due in November 2017 is net of a fair value discount of \$20,000. The original discount recorded on July 1, 2011 was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At December 31, 2016, the Bank's public deposits totaled \$207,740,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At December 31, 2016, the Company had \$130,700,000 in letters of credit with the FHLB outstanding as well as \$135,285,000 in agency, state, and municipal securities to provide collateral for such deposits.

Note 12 – Junior Subordinated Debt

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a wholly owned subsidiary of the Company, issued \$20,000,000 of preferred securities in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company's option beginning on September 30, 2011. Initially, the securities required quarterly distributions by the trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective September 30, 2011, the rate resets quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to 20 consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities. The proceeds of the Trust Preferred Securities received by the trust, along with proceeds of \$619,000 received by the trust from the issuance of common securities by the trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a junior subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company, and for general corporate purposes. On July 1, 2011, in connection with the MidCarolina merger, the Company assumed \$8,764,000 in junior subordinated debentures to the MidCarolina Trusts, to fully and unconditionally guarantee the preferred securities issued by the MidCarolina Trusts. These long-term obligations, which currently qualify as Tier 1 capital, constitute a full and unconditional guarantee by the Company of the MidCarolina Trusts' obligations. The MidCarolina Trusts are not consolidated in the Company's financial statements.

In accordance with ASC 810-10-15-14, "Consolidation – Overall - Scope and Scope Exceptions," the Company did not eliminate through consolidation the Company's \$619,000 equity investment in AMNB Statutory Trust I or the \$264,000 equity investment in the MidCarolina Trusts. Instead, the Company reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

A description of the junior subordinated debt securities outstanding payable to the trusts is shown below (dollars in thousands):

Issuing Entity	Date Issued	Interest Rate	Maturity Date	Principal Amount	
				December 31, 2016	2015
AMNB Trust I	4/7/2006	Libor plus 1.35%	6/30/2036	\$20,619	\$20,619
MidCarolina Trust I	10/29/2002	Libor plus 3.45%	11/7/2032	4,265	4,209
MidCarolina Trust II	12/3/2003	Libor plus 2.95%	10/7/2033	2,840	2,794
				\$27,724	\$27,622

The principal amounts reflected for the MidCarolina Trusts are net of fair value marks of \$890,000 and \$769,000 respectively. The original fair value marks of \$1,197,000 and \$1,021,000 were recorded as a result of the merger with MidCarolina on July 1, 2011 and are being amortized into interest expense over the remaining lives of the respective borrowings.

Note 13 – Stock-Based Compensation

The Company's 2008 Stock Incentive Plan ("2008 Plan") was adopted by the Board of Directors of the Company on February 19, 2008 and approved by shareholders on April 22, 2008 at the Company's 2008 Annual Meeting of Shareholders. The 2008 Plan provides for the granting of restricted stock awards, incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board of Directors or a Board designated committee. The 2008 Plan authorizes the issuance of up to 500,000 shares of common stock. The 2008 Plan replaced the Company's stock option plan that was approved by the shareholders at the 1997 Annual Meeting, which plan terminated in 2006.

Stock Options

Accounting guidance requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued.

A summary of stock option transactions for the year ended December 31, 2016 is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at December 31, 2015	67,871	\$ 24.47		
Replacement stock options Granted	—	—		
Exercised	5,784	24.46		
Forfeited	—	—		
Expired	3,676	26.05		
Outstanding at December 31, 2016	58,411	\$ 24.37	1.75 years	\$ 618
Exercisable at December 31, 2016	58,411	\$ 24.37	1.75 years	\$ 618

The aggregate intrinsic value of stock options in the table above represents the total pre-tax intrinsic value (the amount by which the current fair value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2016. This amount changes based on changes in the fair value of the Company's common stock.

The total proceeds of the in-the-money options exercised during the year ended December 31, 2016, 2015, and 2014 were \$142,000, \$789,000, and \$442,000, respectively. Total intrinsic value of options exercised during years ended December 31, 2016, 2015, and 2014 was \$11,000, \$220,000, and \$178,000, respectively.

As of December 31, 2016, 2015, and 2014, there was no recognized or unrecognized compensation expense attributable to the outstanding stock options.

The following table summarizes information related to stock options outstanding on December 31, 2016: Options Outstanding and Exercisable

Range of Exercise Prices	Number of Outstanding Options	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price
\$20.00 to \$25.00	33,166	1.98 years	\$ 22.27
\$25.01 to \$30.00	22,275	1.55	25.82
\$30.01 to \$41.67	2,970	0.70	37.04
	58,411	1.75 years	\$ 24.37

No stock options were granted in 2016, 2015 and 2014.

Restricted Stock

The Company from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company's common stock. The value of the stock awarded is established as the fair market value of the stock at the time of the grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. Restricted stock granted in 2016 cliff vests at the end of a 36-month period beginning on the date of grant. Nonvested restricted stock activity for the year ended December 31, 2016 is summarized in the following table:

Restricted Stock	Shares	Weighted Average Grant Date Value
Nonvested at December 31, 2015	41,563	\$ 22.15
Granted	29,025	23.55
Vested	(19,219)	21.47
Forfeited	(547)	21.98
Nonvested at December 31, 2016	50,822	23.21

As of December 31, 2016, 2015, and 2014, there was \$568,000, \$340,000, and \$327,000, respectively, in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. This cost is expected to be recognized over the next 12 to 36 months. The share based compensation expense for nonvested restricted stock was \$444,000, \$322,000, and \$342,000 during 2016, 2015, and 2014, respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. The regular monthly board retainer can be received quarterly in the form of either (i) \$5,800 in cash or (ii) shares of immediately vested, but restricted stock, with a market value of \$6,250. Monthly meeting fees can also be received as \$600 per meeting in cash or \$900 in immediately vested, but restricted stock. For 2016, 11 of the 13 outside directors elected to receive stock in lieu of cash for either all of part of their retainer or meeting fees. Only outside directors receive board fees. The Company issued 13,166, 11,228 and 13,147 shares and recognized share based compensation expense of \$380,000, \$275,000, and \$305,000 during 2016, 2015 and 2014, respectively.

During 2015, 4,158 shares with a market value of \$95,000 were issued to a retired director as payment for cumulative deferred director compensation.

Note 14 – Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the states of Virginia and North Carolina. With few exceptions, the Company is no longer subject to U.S. federal, state, and local income tax examinations by tax authorities for years prior to 2013.

The components of the Company's net deferred tax assets (liabilities) were as follows (dollars in thousands):

	December 31,	
	2016	2015
Deferred tax assets:		
Allowance for loan losses	\$4,480	\$4,410
Nonaccrual loan interest	610	576
Other real estate owned valuation allowance	199	360
Deferred compensation	1,335	1,353
Net unrealized losses on securities	81	—
Acquisition accounting adjustments	3,215	4,641
Accrued pension liability	100	—
Other	796	840
Total deferred tax assets	10,816	12,180

Deferred tax liabilities:		
Depreciation	1,030	951
Accretion of discounts on securities	113	320
Core deposit intangibles	602	939
Net unrealized gains on securities	—	2,219
Prepaid pension expense	—	9
Trust preferred fair value adjustment	581	616
Other	243	239
Total deferred tax liabilities	2,569	5,293
Net deferred tax assets	\$8,247	\$6,887

The provision for income taxes consists of the following (dollars in thousands):

	Years Ended		
	December 31,		
	2016	2015	2014
Current tax expense	\$6,125	\$4,279	\$5,153
Deferred tax expense	882	1,741	49
Total income tax expense	\$7,007	\$6,020	\$5,202

A reconciliation of the "expected" Federal income tax expense to reported income tax expense is as follows (dollars in thousands):

	Years Ended December		
	31,		
	2016	2015	2014
Expected federal tax expense	\$8,158	\$7,371	\$6,280
Nondeductible interest expense	94	78	63
Tax-exempt interest	(1,265)	(1,338)	(1,370)
State income taxes	296	222	405
Other, net	(276)	(313)	(176)
Total income tax expense	\$7,007	\$6,020	\$5,202

Note 15 – Earnings Per Common Share

The following shows the weighted average number of shares used in computing earnings per common share and the effect on weighted average number of shares of potentially dilutive common stock. Potentially dilutive common stock had no effect on income available to common shareholders. Nonvested restricted shares are included in the computation of basic earnings per share as the holder is entitled to full shareholder benefits during the vesting period including voting rights and sharing in nonforfeitable dividends.

	Years Ended December 31,					
	2016		2015		2014	
	Shares	Per Share Amount	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	8,611,507	\$ 1.89	8,680,502	\$ 1.73	7,867,198	\$ 1.62
Effect of dilutive securities - stock options	9,734	—	7,948	—	10,378	—
Diluted earnings per share	8,621,241	\$ 1.89	8,688,450	\$ 1.73	7,877,576	\$ 1.62

Outstanding stock options on common stock which were not included in computing diluted earnings per share in 2016, 2015, and 2014 because their effects were anti-dilutive, averaged 11,397 shares, 66,238 shares, and 117,843 shares, respectively.

Note 16 – Off-Balance Sheet Activities

The Company is party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if applicable, is based on management's credit evaluation of the customer.

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

The following off-balance sheet financial instruments whose contract amounts represent credit risk were outstanding at December 31, 2016 and 2015 (dollars in thousands):

	December 31,	
	2016	2015
Commitments to extend credit	\$345,803	\$301,360
Standby letters of credit	4,088	4,286
Mortgage loan rate lock commitments	12,839	5,365

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally consist of unused portions of lines of credit issued to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

At December 31, 2016, the Company had locked-rate commitments to originate mortgage loans amounting to approximately \$12,839,000 and loans held for sale of \$5,996,000. Risks arise from the possible inability of counterparties to meet the terms of their contracts, though the Company has never experienced a failure of one of its counterparties to perform. If a loan becomes past due 90 days within 180 days of sale, the Company would be required to repurchase the loan.

Note 17 – Related Party Transactions

In the ordinary course of business, loans are granted to executive officers, directors, and their related entities. Management believes that all such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to similar, unrelated borrowers, and do not involve more than a normal risk of collectibility or present other unfavorable features. As of December 31, 2016 and 2015, none of these loans were restructured, past due, or on nonaccrual status.

An analysis of these loans for 2016 is as follows (dollars in thousands):

Balance at December 31, 2015	\$ 16,338
Additions	21,676
Repayments	(15,846)
Reclassifications ⁽¹⁾	(90)
Balance at December 31, 2016	\$22,078

(1) Includes loans (i) to persons no longer affiliated with the Company and therefore not considered related party loans as of period end or (ii) that were considered related party loans in the prior year but were subsequently not considered related party loans in the current year.

Related party deposits totaled \$22,121,000 at December 31, 2016 and \$17,163,000 at December 31, 2015.

Note 18 – Employee Benefit Plans

Defined Benefit Plan

The Company previously maintained a non-contributory defined benefit pension plan which covered substantially all employees who were 21 years of age or older and who had at least one year of service. The Company froze its pension plan to new participants and converted its pension plan to a cash balance plan effective December 31, 2009. Each year existing participants will receive, with some adjustments, income based on the yield of the 10 year U.S. Treasury Note in December of the preceding year. Information pertaining to the activity in the plan is as follows (dollars in thousands):

	As of and for the Years Ended December 31,		
	2016	2015	2014
Change in Benefit Obligation:			
Projected benefit obligation at beginning of year	\$8,453	\$10,710	\$8,996
Service cost	—	—	—
Interest cost	269	297	304
Actuarial (gain) loss	352	(100)	1,606
Settlement gain	(51)	—	—
Benefits paid	(1,091)	(2,454)	(196)
Projected benefit obligation at end of year	7,932	8,453	10,710
Change in Plan Assets:			
Fair value of plan assets at beginning of year	8,428	10,949	10,870
Actual return on plan assets	310	(67)	275
Benefits paid	(1,091)	(2,454)	(196)
Fair value of plan assets at end of year	7,647	8,428	10,949
Funded Status at End of Year	\$(285)	\$(25)	\$239
Amounts Recognized in the Consolidated Balance Sheets			
Other (liabilities) assets	\$(285)	\$(25)	\$239
Amounts Recognized in Accumulated Other Comprehensive Loss			
Net actuarial loss	\$2,652	\$2,818	\$3,356
Deferred income taxes	(928)	(986)	(1,175)
Amount recognized	\$1,724	\$1,832	\$2,181

	As of and for the Years Ended December 31,		
	2016	2015	2014
Components of Net Periodic Benefit Cost			
Service cost	\$—	\$—	\$—
Interest cost	269	297	304
Expected return on plan assets	(385)	(459)	(469)
Recognized net loss due to settlement	315	671	—
Recognized net actuarial loss	228	293	73
Net periodic benefit cost	\$427	\$802	\$(92)

Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive (Income) Loss

Net actuarial (gain) loss	\$(166)	\$(538)	\$1,728
Amortization of prior service cost	—	—	—
Total recognized in other comprehensive (income) loss	\$(166)	\$(538)	\$1,728

Total Recognized in Net Periodic Benefit Cost and Other Comprehensive (Income) Loss \$262 \$264 \$1,636

The accumulated benefit obligation as of December 31, 2016, 2015, and 2014 was \$7,932,000, \$8,453,000, and \$10,710,000, respectively. The rate of compensation increase is no longer applicable since the defined benefit plan was frozen and converted to a cash balance plan.

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

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

Below is a description of the plan's assets. The plan's weighted-average asset allocations by asset category are as follows as of December 31, 2016 and 2015:

Asset Category	December 31,	
	2016	2015
Fixed Income	51.3 %	59.5 %
Equity	38.0 %	32.0 %
Cash and Accrued Income	10.7 %	8.5 %
Total	100.0%	100.0%

The investment policy and strategy for plan assets can best be described as a growth and income strategy.

Diversification is accomplished by limiting the holding of any one equity issuer to no more than 5% of total equities. Exchange traded funds are used to provide diversified exposure to the small capitalization and international equity markets. All fixed income investments are rated as investment grade, with the majority of these assets invested in corporate issues. The assets are managed by the Company's Trust and Investment Services Division. No derivatives are used to manage the assets. Equity securities do not include holdings in the Company.

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

The fair value of the Company's pension plan assets at December 31, 2016 and 2015, by asset category are as follows (dollars in thousands):

Asset Category	Balance at December 31, 2016	Fair Value Measurements at December 31, 2016 using Quoted Prices		
		in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Cash	\$ 780	\$780	\$ —	\$ —
Fixed income securities				
Government sponsored entities	1,496	—	1,496	—
Municipal bonds and notes	1,453	—	1,453	—
Corporate bonds and notes	973	—	973	—
Equity securities				
U.S. companies	2,505	2,505	—	—
Foreign companies	440	440	—	—
	\$ 7,647	\$3,725	\$ 3,922	\$ —
Asset Category	Balance at December 31, 2015	Fair Value Measurements at December 31, 2015 using Quoted Prices		
		in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Cash	\$ 675	\$675	\$ —	\$ —
Fixed income securities				
Government sponsored entities	2,287	—	2,287	—
Municipal bonds and notes	1,084	—	1,084	—
Corporate bonds and notes	1,641	—	1,641	—
Equity securities				
U.S. companies	2,481	2,481	—	—
Foreign companies	260	260	—	—
	\$ 8,428	\$3,416	\$ 5,012	\$ —

Projected benefit payments for the years 2017 to 2026 are as follows (dollars in thousands):

Year	Amount
2017	\$ 1,033
2018	514
2019	1,053
2020	423

2021 624
2022-20263,151
401(k) Plan

The Company maintains a 401(k) plan that covers substantially all full-time employees of the Company. The Company matches a portion of the contribution made by employee participants after at least one year of service. The Company contributed \$623,000, \$602,000, and \$521,000 to the 401(k) plan in 2016, 2015, and 2014, respectively. These amounts are included in employee benefits expense for the respective years.

95

Deferred Compensation Arrangements

The Company has historically maintained deferred compensation agreements with certain current and former employees providing for annual payments to each ranging from \$25,000 to \$50,000 per year for ten years upon their retirement. The liabilities under these agreements are being accrued over the officers' remaining periods of employment so that, on the date of their retirement, the then-present value of the annual payments would have been accrued. As of December 31, 2016, the Company only had one remaining agreement under which payments are being made to a former officer. The liabilities were \$397,000 and \$442,000 at December 31, 2016 and 2015, respectively. The expense for these agreements was \$6,000, \$8,000, and \$10,000 for the years 2016, 2015, and 2014, respectively.

Profit Sharing and Incentive Arrangements

Prior to January 1, 2015, the Company maintained a cash profit sharing plan for full-time employees based on the Company's performance and a cash incentive compensation plan for officers based on the Company's performance and individual officer goals. As of December 31, 2014, the Company discontinued the profit sharing plan. The total amount charged to salary expense for these plans was \$916,000, \$559,000, and \$851,000 for the years 2016, 2015, and 2014, respectively.

Note 19 – Fair Value Measurements

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the fair value measurements and disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

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

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

In mid-2013, the Company purchased \$1,000,000 in convertible preferred stock from a Virginia based, publicly traded community bank. There was no secondary market for this bank's preferred stock; however, its common stock is traded on a public stock exchange. The Company used an independent third party to assist in the valuation of these securities at December 31, 2015. Given the convertible nature of the securities, the common stock of the issuing community bank was used as a proxy for the preferred stock value. This was the only security recorded with a Level 3 valuation at December 31, 2015. The Company's investment in the preferred stock was converted into common stock at June 29, 2016. Consequently, there were no securities recorded with a Level 3 valuation at December 31, 2016.

The following table presents the balances of financial assets measured at fair value on a recurring basis during the period (dollars in thousands):

Description	Balance as of December 31, 2016	Fair Value Measurements at December 31, 2016 Using Quoted Prices		
		in Significant Other Markets for Identical Assets	Significant Unobservable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$ 104,054	\$ -	\$ 104,054	\$ —
Mortgage-backed and CMOs	79,493	—	79,493	—
State and municipal	147,515	—	147,515	—
Corporate	13,492	—	13,492	—
Equity securities	1,948	—	1,948	—
Total	\$ 346,502	\$ -	\$ 346,502	\$ —

Description	Balance as of December 31, 2015	Fair Value Measurements at December 31, 2015 Using Quoted Prices		
		in Significant Other Markets for Identical Assets	Significant Unobservable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$ 81,452	\$ -	\$ 81,452	\$ —
Mortgage-backed and CMOs	70,930	—	70,930	—
State and municipal	175,891	—	175,891	—
Corporate	10,590	—	10,590	—
Equity Securities	1,486	—	—	1,486
Total	\$ 340,349	\$ -	\$ 338,863	\$ 1,486

Fair Value Measurements Using Significant Unobservable Inputs
(Level 3)

	Balances as of January 1, 2016	Total Realized / Unrealized Gains (Losses) Included in Net Other Comprehensive Income	Purchases, Sales, Issuances and Settlements, Net	Transfer In (Out) of Level 3	Balances as of December 31, 2016
Securities available for sale:					
Equity	\$ 1,486	\$ — 93	\$ —	\$(1,579)	\$ —
Total assets	\$ 1,486	\$ — 93	\$ —	\$(1,579)	\$ —

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 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 during the years ended December 31, 2016 and 2015. Gains and losses on the sale of loans are recorded within mortgage banking income on the Consolidated Statements of Income.

Impaired loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected when due. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparable or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Other real estate owned: Measurement for fair values for other real estate owned are the same as impaired loans. Any fair value adjustments are recorded in the period incurred as a valuation allowance against other real estate owned with the associated expense included in other real estate owned expense, net on the Consolidated Statements of Income.

The following table summarizes the Company's assets that were measured at fair value on a nonrecurring basis during the period (dollars in thousands):

Description	Balance as of December 31, 2016	Fair Value Measurements at December 31, 2016 Using		
		Quoted Prices in Significant Other Observable Markets for Identical Assets	Significant Unobservable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$ 5,996	\$ —	\$ 5,996	\$ —
Impaired loans, net of valuation allowance	2,151	—	—	2,151
Other real estate owned, net	1,328	—	—	1,328
		Fair Value Measurements at December 31, 2015 Using Significant Significant		

Description	Balance as of December 31, 2015	Quoted	Unobservable
		Observable Inputs	Inputs
		in Active Markets for Identical Assets Level 1	Level 2 Level 3
Assets:			
Loans held for sale	\$ 3,266	\$ —	\$ 3,266 —
Impaired loans, net of valuation allowance	2,948	—	— 2,948
Other real estate owned, net	2,184	—	— 2,184

Quantitative Information About Level 3 Fair Value Measurements as of December 31, 2016:

Assets	Valuation Technique	Unobservable Input	Weighted Rate
Impaired loans	Discounted appraised value	Selling cost	8 %

Other real estate owned Discounted appraised value Selling cost 6 %

Quantitative Information About Level 3 Fair Value Measurements as of December 31, 2015:

Assets	Valuation Technique	Unobservable Input	Weighted Rate
Securities available for sale	Third party model based techniques	Stock price in different rate environments	49 %
Impaired loans	Discounted appraised value	Selling cost	6 %
	Discounted cash flow analysis	Market rate for borrower (discount rate)	4 %
Other real estate owned	Discounted appraised value	Selling cost	6 %

ASC 825, "Financial Instruments," requires disclosure about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. The carrying values and estimated fair values of the Company's financial instruments at December 31, 2016 are as follows (dollars in thousands):

Fair Value Measurements at December 31, 2016 Using

	Carrying Value	Quoted Prices in Active Markets for Identical Assets			Fair Value Balance
		Level 1	Level 2	Level 3	
Financial Assets:					
Cash and cash equivalents	\$53,207	\$53,207	\$—	\$—	\$53,207
Securities available for sale	346,502	—	346,502	—	346,502
Restricted stock	6,224	—	6,224	—	6,224
Loans held for sale	5,996	—	5,996	—	5,996
Loans, net of allowance	1,152,020	—	—	1,136,961	1,136,961
Bank owned life insurance	18,163	—	18,163	—	18,163
Accrued interest receivable	5,083	—	5,083	—	5,083
Financial Liabilities:					
Deposits	\$1,370,640	\$—	\$991,785	\$374,774	\$1,366,559
Repurchase agreements	39,166	—	39,166	—	39,166
Other short-term borrowings	20,000	—	20,000	—	20,000
Long-term borrowings	9,980	—	—	10,156	10,156
Junior subordinated debt	27,724	—	—	24,932	24,932
Accrued interest payable	623	—	623	—	623

The carrying values and estimated fair values of the Company's financial instruments at December 31, 2015 are as follows (dollars in thousands):

	Fair Value Measurements at December 31, 2015 Using				Fair Value Balance
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
Financial Assets:					
Cash and cash equivalents	\$95,337	\$95,337	\$—	\$—	\$95,337
Securities available for sale	340,349	—	338,863	1,486	340,349
Restricted stock	5,312	—	5,312	—	5,312
Loans held for sale	3,266	—	3,266	—	3,266
Loans, net of allowance	992,924	—	—	994,808	994,808
Bank owned life insurance	17,658	—	17,658	—	17,658
Accrued interest receivable	4,116	—	4,116	—	4,116
Financial Liabilities:					
Deposits	\$1,262,660	\$—	\$865,350	\$396,551	\$1,261,901
Repurchase agreements	40,611	—	40,611	—	40,611
Other borrowings	9,958	—	—	10,293	10,293
Junior subordinated debt	27,622	—	—	22,940	22,940
Accrued interest payable	655	—	655	—	655

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

Cash and cash equivalents. The carrying amount is a reasonable estimate of fair value.

Securities. Fair values are based on quoted market prices or dealer quotes.

Restricted stock. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

Loans held for sale. The carrying amount is at fair value.

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

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

Accrued interest receivable. The carrying amount is a reasonable estimate of fair value.

Deposits. The fair value of demand deposits, savings deposits, and money market deposits equals the carrying value. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposit instruments would be offered to depositors for the same remaining maturities.

Repurchase agreements. The carrying amount is a reasonable estimate of fair value.

Other short-term borrowings. The carrying amount is a reasonable estimate of fair value.

Long-term borrowings. The fair values of long-term borrowings are estimated using discounted cash flow analysis based on the interest rates for similar types of borrowing arrangements.

Junior subordinated debt. Fair value is calculated by discounting the future cash flows using the estimated current interest rates at which similar securities would be issued.

Accrued interest payable. The carrying amount is a reasonable estimate of fair value.

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2016 and 2015, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the table above. The various off-balance sheet instruments were discussed in Note 16.

The Company assumes interest rate risk (the risk that interest rates will change) in its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rates change and that change may be either favorable or unfavorable to the Company.

Note 20 – Dividend Restrictions and Regulatory Capital

The approval of the Office of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the bank's retained net income, as defined, for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Bank can distribute as dividends to the Company, without the approval of the Office of the Comptroller of the Currency, \$2,484,000 as of December 31, 2016. Dividends paid by the Bank to the Company are the only significant source of funding for dividends paid by the Company to its shareholders.

Banks and bank holding companies are subject to various regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate certain regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities and unfunded pension liability is included in computing regulatory capital. Management believes as of December 31, 2015, the Company and Bank meet all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2016 and 2015, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-K

Actual and required capital amounts (in thousands) and ratios are presented below at year-end:

	Actual		Required for Capital Adequacy Purposes*		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016						
Common Equity Tier 1						
Company	\$158,350	11.77%	\$60,561	>5.125%		
Bank	172,927	12.92	60,216	>5.125	\$86,979	>6.50 %
Tier 1 Capital						
Company	186,074	13.83	80,748	>6.625		
Bank	172,927	12.92	80,288	>6.625	107,051	>8.00
Total Capital						
Company	199,375	14.81	107,664	>8.625		
Bank	185,931	13.89	107,051	>8.625	133,814	>10.00
Leverage Capital						
Company	186,074	11.67	63,761	>4.00		
Bank	172,927	10.88	63,571	>4.00	79,464	>5.00
December 31, 2015						
Common Equity Tier 1						
Company	\$150,916	12.88%	\$52,739	>4.50 %		
Bank	170,741	14.58	52,691	>4.50	\$76,109	>6.50 %
Tier 1 Capital						
Company	178,538	15.23	70,319	>6.00		
Bank	170,741	14.58	70,255	>6.00	93,673	>8.00
Total Capital						
Company	191,542	16.34	93,758	>8.00		
Bank	183,526	15.67	93,673	>8.00	117,091	>10.00
Leverage Capital						
Company	178,538	12.05	59,260	>4.00		
Bank	170,741	11.54	59,187	>4.00	73,984	>5.00

Except with regard to the Company's and the Bank's leverage capital ratio, includes the current phased-in portion of the Basel III Capital Rules capital conservation buffer (0.625%) which is added to the minimum capital requirements for capital adequacy purposes. The capital conservation buffer requirement began being phased in effective January * 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

Note 21 – Segment and Related Information

The Company has two reportable segments, community banking and trust and investment services.

Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Company are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts, and non-deposit fees such as automated teller machine fees and insurance commissions generate additional income for the community banking segment.

Trust and investment services include estate planning, trust account administration, investment management, and retail brokerage. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services segment receives fees for investment and administrative services.

Amounts shown in the "Other" column include activities of the Company which are primarily debt service on trust preferred securities and corporate items.

Segment information as of and for the years ended December 31, 2016, 2015, and 2014, is shown in the following table (dollars in thousands):

	2016				
	Community Banking	Trust and Investment Services	Other	Intersegment Elimination	Total
Interest income	\$ 56,076	\$ —	\$ 94	\$ —	\$ 56,170
Interest expense	5,438	—	878	—	6,316
Noninterest income	8,848	4,634	23	—	13,505
Income (loss) before income taxes	22,230	2,623	(1,545)	—	23,308
Net income (loss)	15,486	1,835	(1,020)	—	16,301
Depreciation and amortization	2,845	11	—	—	2,856
Total assets	1,669,629	—	229,241	(220,232)	1,678,638
Goodwill	43,872	—	—	—	43,872
Capital expenditures	3,609	4	—	—	3,613
			2015		
	Community Banking	Trust and Investment Services	Other	Intersegment Elimination	Total
Interest income	\$ 55,109	\$ —	\$ 60	\$ —	\$ 55,169
Interest expense	5,144	—	760	—	5,904
Noninterest income	8,386	4,881	20	—	13,287
Income (loss) before income taxes	19,398	2,737	(1,076)	—	21,059
Net income (loss)	13,793	1,956	(710)	—	15,039
Depreciation and amortization	3,022	12	—	—	3,034
Total assets	1,545,377	—	225,533	(223,311)	1,547,599
Goodwill	43,872	—	—	—	43,872
Capital expenditures	1,453	21	—	—	1,474

	2014				
	Community Banking	Trust and Investment Services	Other	Intersegment Elimination	Total
Interest income	\$ 47,395	\$ —	\$ 60	\$ —	\$ 47,455
Interest expense	4,988	—	742	—	5,730
Noninterest income	6,317	4,840	19	—	11,176
Income (loss) before income taxes	15,953	3,012	(1,022)	—	17,943
Net income (loss)	11,277	2,138	(674)	—	12,741
Depreciation and amortization	2,791	11	—	—	2,802
Total assets	1,338,465	—	201,482	(193,455)	1,346,492
Goodwill	39,043	—	—	—	39,043
Capital expenditures	1,046	3	—	—	1,049

Note 22 – Parent Company Financial Information

Condensed Parent Company financial information is as follows (dollars in thousands):

	December 31,	
Condensed Balance Sheets	2016	2015
Cash	\$4,654	\$5,571
Securities available for sale, at fair value	8,355	1,486
Investment in subsidiaries	216,340	218,543
Due from subsidiaries	120	85
Other assets	40	18
Total Assets	\$229,509	\$225,703

Junior subordinated debt	\$27,724	\$27,622
Other liabilities	405	246
Shareholders' equity	201,380	197,835
Total Liabilities and Shareholders' Equity	\$229,509	\$225,703

	Years Ended December 31,		
Condensed Statements of Income	2016	2015	2014
Dividends from subsidiary	\$16,000	\$11,000	\$17,000
Other income	117	80	79
Expenses	1,662	1,156	1,100
Income taxes (benefit)	(526)	(366)	(347)
Income before equity in undistributed earnings of subsidiary	14,981	10,290	16,326
Equity in (distributed) undistributed earnings of subsidiary	1,320	4,749	(3,585)
Net Income	\$16,301	\$15,039	\$12,741

Condensed Statements of Cash Flows	Years Ended December 31,		
	2016	2015	2014
Cash Flows from Operating Activities:			
Net income	\$ 16,301	\$ 15,039	\$ 12,741
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in (undistributed) distributions of subsidiary	(1,320)	(4,749)	3,585
Net change in other assets	(57)	257	(17)
Net change in other liabilities	163	106	102
Net cash provided by operating activities	15,087	10,653	16,411
Cash Flows from Investing Activities:			
Purchases of securities available for sale	(6,588)	—	—
Investment in banking subsidiary	—	563	—
Cash paid in bank acquisition	—	(5,935)	—
Net cash used in investing activities	(6,588)	(5,372)	—
Cash Flows from Financing Activities:			
Common stock dividends paid	(8,266)	(8,068)	(7,237)
Repurchase of common stock	(1,292)	(3,506)	(1,508)
Proceeds from exercise of stock options	142	789	442
Proceeds from issuance of common stock	—	95	—
Net cash used in financing activities	(9,416)	(10,690)	(8,303)
Net increase (decrease) in cash and cash equivalents	(917)	(5,409)	8,108
Cash and cash equivalents at beginning of period	5,571	10,980	2,872
Cash and cash equivalents at end of period	\$ 4,654	\$ 5,571	\$ 10,980

Note 23 – Concentrations of Credit Risk

Substantially all the Company's loans are made within its market area, which includes Southern and Central Virginia and the northern portion of Central North Carolina. The ultimate collectibility of the Company's loan portfolio and the ability to realize the value of any underlying collateral, if necessary, are impacted by the economic conditions and real estate values of the market area.

Loans secured by real estate were \$951,073,000, or 81.6% of the loan portfolio at December 31, 2016, and \$822,037,000, or 81.8% of the loan portfolio at December 31, 2015. Loans secured by commercial real estate represented the largest portion of loans at \$510,960,000 at December 31, 2016 and \$430,186,000 at December 31, 2015, 43.9% and 42.8%, respectively of total loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2016 or 2015, nonowner-occupied nonresidential loans represented 20.2% of total loans at December 31, 2016 and 18.7% at December 31, 2015; the lessees and lessors are engaged in a variety of industries.

Note 24 – Supplemental Cash Flow Information

(dollars in thousands)

For the Years ended
December 31,

2016 2015 2014

Supplemental Schedule of Cash and Cash Equivalents:

Cash and due from banks	\$20,268	\$19,352	\$29,272
Interest-bearing deposits in other banks	32,939	75,985	38,031
	\$53,207	\$95,337	\$67,303

Supplemental Disclosure of Cash Flow Information:

Cash paid for:

Interest on deposits and borrowed funds	\$6,348	\$5,836	\$5,753
Income taxes	6,477	3,090	4,371

Noncash investing and financing activities:

Transfer of loans to other real estate owned	295	2,101	386
Unrealized gain (loss) on securities available for sale	(6,572)	(2,652)	3,488
Change in unfunded pension liability	166	538	(1,728)

Non-cash transactions related to acquisitions:

Investment securities	—	18,507	—
Restricted stock	—	587	—
Loans	—	115,960	—
Premises and equipment	—	956	—
Deferred income taxes	—	2,794	—
Core deposit intangible	—	1,839	—
Other real estate owned, net	—	168	—
Bank owned life insurance	—	1,955	—
Other assets	—	1,049	—

Liabilities assumed:

Demand, MMDA, and savings deposits	—	82,451	—
Time deposits	—	54,872	—
Other liabilities	—	3,076	—

Consideration:

Issuance of common stock	—	20,483	—
--------------------------	---	--------	---

Note 25 – Accumulated Other Comprehensive Income ("AOCI")

Changes in each component of accumulated other comprehensive income (loss) were as follows (dollars in thousands):

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2013	\$ 3,578	\$ (1,058)	\$ 2,520
Net unrealized gains on securities available for sale, net of tax, \$1,398	2,595	—	2,595
Reclassification adjustment for realized gains on securities, net of tax, \$(177)	(328)	—	(328)
Change in unfunded pension liability, net of tax, \$(605)	—	(1,123)	(1,123)
Balance at December 31, 2014	5,845	(2,181)	3,664
Net unrealized losses on securities available for sale, net of tax, \$(626)	(1,159)	—	(1,159)
Reclassification adjustment for realized gains on securities, net of tax, \$(303)	(564)	—	(564)
Change in unfunded pension liability, net of tax, \$189	—	349	349
Balance at December 31, 2015	4,122	(1,832)	2,290
Net unrealized losses on securities available for sale, net of tax, \$(2,007)	(3,729)	—	(3,729)
Reclassification adjustment for realized gains on securities, net of tax, \$(293)	(543)	—	(543)
Change in unfunded pension liability, net of tax, \$58	—	108	108
Balance at December 31, 2016	\$ (150)	\$ (1,724)	\$ (1,874)

The following table provides information regarding reclassifications out of accumulated other comprehensive income (loss) (dollars in thousands):

Reclassifications Out of Accumulated Other Comprehensive Income (Loss)

For the Three Years Ending December 31, 2016

Details about AOCI Components	Amount Reclassified from AOCI Years Ended December 31,			Affected Line Item in the Statement of Where Net Income is Presented
	2016	2015	2014	
Available for sale securities:				
Realized gain on sale of securities	\$836	\$867	\$505	Securities gains (losses), net
	(293)	(303)	(177)	Income taxes

Total reclassifications \$543 \$564 \$328 Net of tax

107

ITEM 9A – CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act), as of December 31, 2016. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended December 31, 2016 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Management regularly monitors its internal control over financial reporting, and actions are taken to correct deficiencies as they are identified.

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting. This assessment was based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. Based on this evaluation under the framework in Internal Control – Integrated Framework, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2016, as such term is defined in Exchange Act Rule 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, because of changes in conditions, internal control effectiveness may vary over time.

The Company's independent registered public accounting firm, Yount, Hyde and Barbour, P.C., has audited the Company's internal control over financial reporting as of December 31, 2016, as stated in their report included herein. Yount, Hyde and Barbour, P.C. also audited the Company's consolidated financial statements as of and for the year ended December 31, 2016.

/s/ Jeffrey V. Haley

Jeffrey V. Haley

President and Chief Executive Officer

/s/ William W. Traynham

William W. Traynham

Executive Vice President and

Chief Financial Officer

March 16, 2017

PART IV

ITEM 15 – EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements. See Item 8 for reference.

(a)(2) Financial Statement Schedules. All applicable financial statement schedules required under Regulation S-X have been included in the Notes to the Consolidated Financial Statements.

(a)(3) Exhibits. The exhibits required by Item 601 of Regulation S-K are listed below.

EXHIBIT INDEX

Exhibit No.	Description	Location
2.1	Agreement and Plan of Reorganization, as of August 24, 2014, between American National Bankshares Inc. and MainStreet BankShares, Inc.	Exhibit 2.1 on Form 8-K filed August 28, 2014
3.1	Articles of Incorporation, as amended	Exhibit 3.1 on Form 10-Q filed July 5, 2011
3.2	Bylaws, as amended	Exhibit 3.2 on Form 8-K filed January 5, 2015
10.1	Deferred Compensation Agreement between American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008	Exhibit 10.1 on Form 10-K filed March 16, 2009
10.2	Employment Agreement between American National Bankshares Inc. and Jeffrey V. Haley dated March 2, 2015	Exhibit 10.1 on Form 8-K filed March 4, 2015
10.3	Employment Agreement between American National Bankshares Inc. and William W. Traynham dated March 2, 2015	Exhibit 10.2 on Form 8-K filed March 4, 2015
10.4	Employment Agreement between American National Bankshares Inc. and R. Helm Dobbins dated March 2, 2015	Exhibit 10.1 on Form 10-Q filed May 11, 2015
10.5	Employment Agreement between American National Bankshares Inc. and H. Gregg Strader dated March 2, 2015	Exhibit 10.3 on Form 10-Q filed May 11, 2015
10.6	Employment Agreement between American National Bank and Trust Company, and Charles T. Canaday, Jr., dated December 15, 2010	Exhibit 10.9 on Amendment No. 1 to Form S-4 filed March 29, 2011
10.7	Employment Agreement between American National Bank and Trust Company and Edward C. Martin dated September 21, 2016	Exhibit 10.1 on Form 8-K filed December 29, 2016
10.8	Employment Agreement between American National Bankshares Inc. and Ramsey K. Hamadi dated June 24, 2016	Exhibit 10.2 on Form 8-K filed December 29, 2016
10.9	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Charles T. Canaday, Jr. dated December 15, 2010	Exhibit 10.10 on Amendment No. 1 to Form S-4 filed March 29, 2011

EXHIBIT INDEX

Exhibit No.	Description	Location
10.10	American National Bankshares Inc. 2008 Stock Incentive Plan	Exhibit 99.0 on Form S-8 filed May 30, 2008
10.11	American National Bankshares Inc. 1997 Stock Option Plan	Exhibit 4.3 on Form S-8 filed September 17, 1997
10.12	Adoption Agreement for Virginia Bankers Association Non-Qualified Deferred Compensation Plan for Executives of American National Bank & Trust Company	Exhibit 10.11 on Form 10-K filed March 15, 2016
11.1	Refer to Earnings Per Share calculation in the Notes to Financial Statements	Filed herewith
21.1	Subsidiaries of the registrant	Filed herewith
23.1	Consent of Yount, Hyde & Barbour, P.C.	Filed herewith
31.1	Section 302 Certification of Jeffrey V. Haley, President and Chief Executive Officer	Filed herewith
31.2	Section 302 Certification of William W. Traynham, Executive Vice President and Chief Financial Officer	Filed herewith
32.1	Section 906 Certification of Jeffrey V. Haley, President and Chief Executive Officer	Filed herewith
32.2	Section 906 Certification of William W. Traynham, Executive Vice President and Chief Financial Officer	Filed herewith
101.INS	XBRL Instance Document	
101.SCH	XBRL Taxonomy Extension Schema Document	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
101.PRE	SBRL Taxonomy Presentation Linkbase Document	

ITEM 16 – FORM 10-K SUMMARY

None

SIGNATURES

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

March 16, 2017

AMERICAN NATIONAL
BANKSHARES INC.

By: /s/ Jeffrey V. Haley
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 16, 2017.

/s/ Jeffrey V. Haley Director, President and
Jeffrey V. Haley Chief Executive Officer
(principal executive officer)

/s/ Charles H. Majors	Director and Chairman	/s/ John H. Love	Director
Charles H. Majors		John H. Love	

/s/ Fred A. Blair	Director	/s/ Franklin W. Maddux	Director
Fred A. Blair		Franklin W. Maddux	

/s/ Frank C. Crist, Jr.	Director	/s/ Claude B. Owen, Jr.	Director
Frank C. Crist, Jr.		Claude B. Owen, Jr.	

/s/ Ben J. Davenport, Jr.	Director	/s/ Ronda Penn	Director
Ben J. Davenport, Jr.		Ronda Penn	

/s/ Michael P. Haley	Director	/s/ Dan M. Pleasant	Director
Michael P. Haley		Dan M. Pleasant	

/s/ Charles S. Harris	Director	/s/ Joel R. Shepherd	Director
Charles S. Harris		Joel R. Shepherd	

/s/ F. D. Hornaday, III	Director	/s/ William W. Traynham	Executive Vice President and Chief Financial Officer (principal financial officer)
F. D. Hornaday, III		William W. Traynham	

/s/ Cathy W. Liles Senior Vice President and
Cathy W. Liles Chief Accounting Officer
(principal accounting officer)