

AMERICAN NATIONAL BANKSHARES INC.  
Form 10-Q  
November 07, 2016  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2016.

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

Commission file number: 0-12820

AMERICAN NATIONAL BANKSHARES INC.  
(Exact name of registrant as specified in its charter)

VIRGINIA 54-1284688  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

628 Main Street  
Danville, Virginia 24541  
(Address of principal executive offices) (Zip Code)

(434) 792-5111  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months.

Yes  No

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 the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

At November 2, 2016, the Company had 8,615,473 shares of Common Stock outstanding, \$1 par value.

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AMERICAN NATIONAL BANKSHARES INC.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

American National Bankshares Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share data)

	(Unaudited)	(*)
	September 30,	December 31,
	2016	2015
Assets		
Cash and due from banks	\$ 37,679	\$ 19,352
Interest-bearing deposits in other banks	35,138	75,985
Securities available for sale, at fair value	351,439	340,349
Restricted stock, at cost	6,006	5,312
Loans held for sale	4,776	3,266
Loans, net of unearned income	1,083,201	1,005,525
Less allowance for loan losses	(12,757)	(12,601)
Net loans	1,070,444	992,924
Premises and equipment, net	22,846	23,567
Other real estate owned, net of valuation allowance \$134 in 2016 and \$329 in 2015	1,145	2,184
Goodwill	43,872	43,872
Core deposit intangibles, net	1,894	2,683
Bank owned life insurance	17,998	17,658
Accrued interest receivable and other assets	22,297	20,447
Total assets	\$ 1,615,534	\$ 1,547,599
Liabilities		
Demand deposits -- noninterest bearing	\$ 339,797	\$ 322,442
Demand deposits -- interest bearing	196,696	227,030
Money market deposits	255,748	200,495
Savings deposits	119,476	115,383
Time deposits	394,291	397,310
Total deposits	1,306,008	1,262,660
Customer repurchase agreements	44,090	40,611
Other short-term borrowings	15,000	—
Long-term borrowings	9,974	9,958
Junior subordinated debt	27,698	27,622
Accrued interest payable and other liabilities	9,051	8,913
Total liabilities	1,411,821	1,349,764
Shareholders' equity		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	—	—
Common stock, \$1 par, 20,000,000 shares authorized, 8,610,741 shares outstanding at September 30, 2016 and 8,622,007 shares outstanding at December 31, 2015	8,573	8,605
Capital in excess of par value	74,839	75,375
Retained earnings	117,543	111,565

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Accumulated other comprehensive income, net	2,758	2,290
Total shareholders' equity	203,713	197,835
Total liabilities and shareholders' equity	\$ 1,615,534	\$ 1,547,599

(\* ) - Derived from audited consolidated financial statements.

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

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American National Bankshares Inc.  
Consolidated Statements of Income

(Dollars in thousands, except share and per share data) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
<b>Interest and Dividend Income:</b>				
Interest and fees on loans	\$12,032	\$11,474	\$35,789	\$35,011
Interest on federal funds sold	—	1	—	6
<b>Interest and dividends on securities:</b>				
Taxable	1,112	1,052	3,346	3,021
Tax-exempt	767	899	2,407	2,799
Dividends	74	91	258	258
Other interest income	78	25	203	123
Total interest and dividend income	14,063	13,542	42,003	41,218
<b>Interest Expense:</b>				
Interest on deposits	1,291	1,205	3,902	3,583
Interest on short-term borrowings	4	2	6	7
Interest on long-term borrowings	81	82	243	243
Interest on junior subordinated debt	223	192	644	564
Total interest expense	1,599	1,481	4,795	4,397
Net Interest Income	12,464	12,061	37,208	36,821
Provision for Loan Losses	100	—	200	700
Net Interest Income After Provision for Loan Losses	12,364	12,061	37,008	36,121
<b>Noninterest Income:</b>				
Trust fees	938	1,006	2,829	2,963
Service charges on deposit accounts	514	521	1,520	1,543
Other fees and commissions	663	592	1,991	1,787
Mortgage banking income	512	376	1,169	987
Securities gains, net	73	6	661	553
Brokerage fees	209	255	636	681
Income from Small Business Investment Companies	—	99	238	427
Other	211	200	740	528
Total noninterest income	3,120	3,055	9,784	9,469
<b>Noninterest Expense:</b>				
Salaries	4,626	4,179	12,872	12,634
Employee benefits	1,034	1,029	3,203	3,215
Occupancy and equipment	1,004	1,094	3,162	3,290
FDIC assessment	138	185	519	565
Bank franchise tax	257	220	769	675
Core deposit intangible amortization	213	300	789	901
Data processing	437	366	1,340	1,311
Software	301	290	872	850
Other real estate owned, net	105	(126)	314	60
Merger related expense	—	87	—	1,948
Other	1,752	1,764	5,601	5,628
Total noninterest expense	9,867	9,388	29,441	31,077
Income Before Income Taxes	5,617	5,728	17,351	14,513

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Income Taxes	1,654	1,691	5,172	4,081
Net Income	\$3,963	\$4,037	\$12,179	\$10,432
Net Income Per Common Share:				
Basic	\$0.46	\$0.47	\$1.41	\$1.20
Diluted	\$0.46	\$0.47	\$1.41	\$1.20
Average Common Shares Outstanding:				
Basic	8,608,323	8,668,618	8,610,100	8,698,394
Diluted	8,618,333	8,676,571	8,618,386	8,706,870

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

American National Bankshares Inc.  
 Consolidated Statements of Comprehensive Income  
 (Dollars in thousands) (Unaudited)

	Three Months Ended September 30,	
	2016	2015
Net income	\$3,963	\$4,037
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	(1,424 )	1,365
Tax effect	499	(478 )
Reclassification adjustment for gains on sales of securities	(73 )	(6 )
Tax effect	25	3
Other comprehensive income (loss)	(973 )	884
Comprehensive income	\$2,990	\$4,921

American National Bankshares Inc.  
 Consolidated Statements of Comprehensive Income  
 (Dollars in thousands) (Unaudited)

	Nine Months Ended September 30,	
	2016	2015
Net income	\$12,179	\$10,432
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	1,381	(29 )
Tax effect	(483 )	10
Reclassification adjustment for gains on sales of securities	(661 )	(553 )
Tax effect	231	194
Other comprehensive income (loss)	468	(378 )
Comprehensive income	\$12,647	\$10,054

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



American National Bankshares Inc.  
Consolidated Statements of Changes in Shareholders' Equity  
(Dollars in thousands, except per share data) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2014	\$ 7,872	\$ 57,650	\$ 104,594	\$ 3,664	\$ 173,780
Net income	—	—	10,432	—	10,432
Other comprehensive loss	—	—	—	(378 )	(378 )
Issuance of common stock (825,586 shares)	826	19,657	—	—	20,483
Stock repurchased (121,636 shares)	(122 )	(2,686 )	—	—	(2,808 )
Stock options exercised (22,074 shares)	22	377	—	—	399
Equity based compensation (30,831 shares)	13	526	—	—	539
Cash dividends paid, \$0.69 per share	—	—	(5,996 )	—	(5,996 )
Balance, September 30, 2015	\$ 8,611	\$ 75,524	\$ 109,030	\$ 3,286	\$ 196,451
Balance, December 31, 2015	\$ 8,605	\$ 75,375	\$ 111,565	\$ 2,290	\$ 197,835
Net income	—	—	12,179	—	12,179
Other comprehensive income	—	—	—	468	468
Stock repurchased (51,384 shares)	(51 )	(1,241 )	—	—	(1,292 )
Stock options exercised (4,134 shares)	4	97	—	—	101
Vesting of restricted stock (5,510 shares)	5	(5 )	—	—	—
Equity based compensation (35,984 shares)	10	613	—	—	623
Cash dividends paid, \$0.72 per share	—	—	(6,201 )	—	(6,201 )
Balance, September 30, 2016	\$ 8,573	\$ 74,839	\$ 117,543	\$ 2,758	\$ 203,713

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

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American National Bankshares Inc.  
 Consolidated Statements of Cash Flows  
 (Dollars in thousands) (Unaudited)

	Nine Months Ended September 30,	
	2016	2015
<b>Cash Flows from Operating Activities:</b>		
Net income	\$12,179	\$10,432
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	200	700
Depreciation	1,409	1,357
Net accretion of acquisition accounting adjustments	(1,709 )	(2,503 )
Core deposit intangible amortization	789	901
Net amortization of securities	2,034	2,062
Net gains on sale or call of securities	(661 )	(553 )
Gain on sale of loans held for sale	(906 )	(771 )
Proceeds from sales of loans held for sale	53,266	42,691
Originations of loans held for sale	(53,870 )	(44,302 )
Net loss (gain) on other real estate owned	72	(199 )
Valuation allowance on other real estate owned	156	86
Net loss on sale of premises and equipment	9	5
Equity based compensation expense	623	539
Net change in bank owned life insurance	(340 )	(343 )
Deferred income tax (benefit) expense	(1,596 )	1,482
Net change in interest receivable	(458 )	491
Net change in other assets	(211 )	107
Net change in interest payable	(18 )	3
Net change in other liabilities	156	(606 )
Net cash provided by operating activities	11,124	11,579
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sales of securities available for sale	9,317	7,429
Proceeds from maturities, calls and paydowns of securities available for sale	116,254	70,759
Purchases of securities available for sale	(137,314)	(75,069 )
Net change in restricted stock	(694 )	(354 )
Net increase in loans	(76,015 )	(24,073 )
Proceeds from sale of premises and equipment	1	42
Purchases of premises and equipment	(536 )	(1,203 )
Proceeds from sales of other real estate owned	908	1,993
Cash paid in bank acquisition	—	(5,935 )
Cash acquired in bank acquisition	—	18,173
Net cash used in investing activities	(88,079 )	(8,238 )
<b>Cash Flows from Financing Activities:</b>		
Net change in demand, money market, and savings deposits	46,367	31,727
Net change in time deposits	(3,019 )	(18,148 )
Net change in customer repurchase agreements	3,479	(9,901 )
Net change in other short-term borrowings	15,000	—
Common stock dividends paid	(6,201 )	(5,996 )

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Repurchase of common stock	(1,292 )	(2,808 )
Proceeds from exercise of stock options	101	399
Net cash provided by (used in) financing activities	54,435	(4,727 )
Net Decrease in Cash and Cash Equivalents	(22,520 )	(1,386 )
Cash and Cash Equivalents at Beginning of Period	95,337	67,303
Cash and Cash Equivalents at End of Period	\$72,817	\$65,917

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

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AMERICAN NATIONAL BANKSHARES INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Accounting Policies

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 consolidated 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, other than temporary impairment, the valuation of deferred tax assets and liabilities, and the valuation of other real estate owned ("OREO").

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 9.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the results of the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may occur for any other period. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These reclassifications did not have an impact on net income and were considered immaterial. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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,

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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.

## Note 2 – Acquisition of MainStreet BankShares, Inc.

On January 1, 2015, the Company completed its acquisition of MainStreet BankShares, Inc. ("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, and a related Plan of Merger. Immediately after the merger, Franklin Community Bank, N.A., 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. Replacement stock option awards representing 43,086 shares of the Company's common stock were granted in conjunction with the MainStreet acquisition.

MainStreet was the holding company for Franklin Community Bank, N.A. As of 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.

The net impact of the amortization and accretion of premiums and discounts associated with the Company's acquisition accounting adjustments related to the MainStreet acquisition had the following impact on the Consolidated Statements of Income during the nine months ended September 30, 2016 and 2015 (dollars in thousands):

	Nine Months Ended	
	September 30, 2016	September 30, 2015
Acquired performing loans	\$203	\$ 317
Acquired impaired loans	445	827
CD valuation	—	216
Brokered CD valuation	—	2
Amortization of core deposit intangible	(185 )	(220 )
Net impact to income before taxes	\$463	\$ 1,142



## Note 3 – Securities

The amortized cost and fair value of investments in debt and equity securities at September 30, 2016 and December 31, 2015 were as follows (dollars in thousands):

	September 30, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$96,840	\$ 225	\$ 87	\$96,978
Mortgage-backed and CMOs	79,631	1,376	20	80,987
State and municipal	157,922	4,924	26	162,820
Corporate	8,697	123	—	8,820
Equity securities	1,288	546	—	1,834
Total securities available for sale	\$344,378	\$ 7,194	\$ 133	\$351,439
	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

## Restricted Stock

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank of Richmond ("FRB") and Federal Home Loan Bank of Atlanta ("FHLB"), these securities have been classified as restricted equity securities and carried at cost. The restricted securities are not subject to the investment security classification and are included as a separate line item on the Company's Consolidated Balance Sheet. The FRB 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. 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 cost of restricted stock at September 30, 2016 and December 31, 2015 was as follows (dollars in thousands):

	September 30, 2016	December 31, 2015
FRB stock	\$ 3,553	\$ 3,535
FHLB stock	2,453	1,777
Total restricted stock	\$ 6,006	\$ 5,312

## 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 September 30, 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	\$35,876	\$ 87	\$35,876	\$ 87	\$—	\$ —
Mortgage-backed and CMOs	2,140	20	334	1	1,806	19
State and municipal	8,906	26	8,089	26	817	—
Total	\$46,922	\$ 133	\$44,299	\$ 114	\$2,623	\$ 19

Federal agencies and GSEs: The unrealized loss on the Company's investment in eight government sponsored entity ("GSE") securities was 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 basis 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 basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2016.

Mortgage-backed securities and CMOs: The unrealized losses on the Company's investment in six GSE mortgage-backed securities and collateralized mortgage obligations ("CMOs") were caused by interest rate increases. 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 basis 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 basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2016.

State and municipal securities: The unrealized losses on 13 state and municipal securities 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 basis 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 basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2016.

Corporate securities: The Company had zero investments with unrealized losses in corporate securities. In prior periods when unrealized losses were shown they were caused by interest rate increases. The contractual terms of those investments did not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company did not intend to sell the investments and it was not more likely than not that the Company would be required to sell the investments before recovery of their amortized cost basis, which may have been maturity, the Company did not consider those investments to be other-than-temporarily impaired at September 30, 2016.

Restricted stock: When evaluating restricted stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider restricted stock to be other-than-temporarily impaired at September 30, 2016, and no impairment has been recognized.

The table below shows estimated fair value and gross unrealized losses, 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

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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 September 30, 2016 and December 31, 2015, there were no securities classified as other-than-temporary impaired.

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## Note 4 – Loans

Loans, excluding loans held for sale, at September 30, 2016 and December 31, 2015, were comprised of the following (dollars in thousands):

	September 30, 2016	December 31, 2015
Commercial	\$ 204,184	\$ 177,481
Commercial real estate:		
Construction and land development	91,688	72,968
Commercial real estate	454,797	430,186
Residential real estate:		
Residential	218,632	220,434
Home equity	108,617	98,449
Consumer	5,283	6,007
Total loans	\$ 1,083,201	\$ 1,005,525

## Acquired Loans

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at September 30, 2016 and December 31, 2015 are as follows (dollars in thousands):

	September 30, 2016	December 31, 2015
Outstanding principal balance	\$ 112,205	\$ 145,380
Carrying amount	103,911	135,254

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

	September 30, 2016	December 31, 2015
Outstanding principal balance	\$ 35,697	\$ 40,951
Carrying amount	29,739	33,878

The following table presents changes in the accretible yield on acquired impaired loans, for which the Company applies FASB ASC 310-30, at September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016	December 31, 2015
Balance at January 1	\$ 7,299	\$ 1,440
Additions from merger with MainStreet	—	7,140
Accretion	(1,079 )	(211 )
Other changes, net	201	(1,070 )
	\$ 6,421	\$ 7,299

## Past Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at September 30, 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	\$ 13	\$ —	\$ —	—\$ 67	\$ 80	\$ 204,104	\$ 204,184
Commercial real estate:							
Construction and land development	15	—	—	66	81	91,607	91,688
Commercial real estate	129	114	—	905	1,148	453,649	454,797
Residential:							
Residential	517	73	—	2,073	2,663	215,969	218,632
Home equity	95	34	—	726	855	107,762	108,617
Consumer	2	18	—	9	29	5,254	5,283
Total	\$ 771	\$ 239	\$ —	—\$ 3,846	\$ 4,856	\$ 1,078,345	\$ 1,083,201

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	—	1,731	3,042	217,392	220,434
Home equity	140	12	—	620	772	97,677	98,449
Consumer	53	1	—	9	63	5,944	6,007
Total	\$ 1,378	\$ 593	\$ —	—\$ 5,205	\$ 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 September 30, 2016 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 25	\$ 25	\$ —	\$ 9	\$ 1
Commercial real estate:					
Construction and land development	238	238	—	238	13
Commercial real estate	1,837	1,838	—	1,282	76
Residential:					
Residential	395	405	—	198	20
Home equity	409	602	—	189	16
Consumer	10	10	—	11	1
	\$ 2,914	\$ 3,118	\$ —	\$ 1,927	\$ 127
With a related allowance recorded:					
Commercial *	67	67	—	93	1
Commercial real estate:					
Construction and land development*	65	66	—	324	10
Commercial real estate*	146	145	—	346	7
Residential					
Residential	1,563	1,565	21	1,582	16
Home equity	316	317	1	335	2
Consumer*	9	9	—	13	—
	\$ 2,166	\$ 2,169	\$ 22	\$ 2,693	\$ 36
Total:					
Commercial	\$ 92	\$ 92	\$ —	\$ 102	\$ 2
Commercial real estate:					
Construction and land development	303	304	—	562	23
Commercial real estate	1,983	1,983	—	1,628	83
Residential:					
Residential	1,958	1,970	21	1,780	36
Home equity	725	919	1	524	18
Consumer	19	19	—	24	1
	\$ 5,080	\$ 5,287	\$ 22	\$ 4,620	\$ 163

\*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 tables show the detail of loans modified as troubled debt restructurings ("TDRs") during the three and nine months ended September 30, 2016 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended September 30, 2016	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	— \$ —	\$ —
Commercial real estate	—	—
Construction and land development	—	—
Home Equity	—	—
Residential real estate	1 56	47
Consumer	—	—
Total	1 \$ 56	\$ 47

Loan Type	Loans Modified as a TDR for the Nine Months Ended September 30, 2016	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	1 \$ 24	\$ 24
Commercial real estate	2 1,005	1,003
Construction and land development	—	—
Home Equity	—	—
Residential real estate	2 58	48
Consumer	—	—
Total	5 \$ 1,087	\$ 1,075

The following tables show the detail of loans modified as TDRs during the three and nine months ended September 30, 2015 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended September 30, 2015	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	2 \$ 52	\$ 31
Commercial real estate	—	—
Construction and land development	—	—
Home Equity	1 106	106
Residential real estate	1 382	294
Consumer	—	—
Total	4 \$ 540	\$ 431



Loans Modified as a TDR for the  
Nine Months Ended September 30,  
2015

Loan Type	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	2	\$ 52	\$ 31
Commercial real estate	3	256	249
Construction and land development	—	—	—
Home Equity	1	106	106
Residential real estate	5	776	680
Consumer	—	—	—
Total	11	\$ 1,190	\$ 1,066

During the three and nine months ended September 30, 2016 and 2015, the Company had no loans that subsequently defaulted within twelve months of modification. The Company defines defaults as one or more payments that occur more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

Residential Real Estate in Process of Foreclosure

The Company had \$1,424,000 in residential real estate loans in the process of foreclosure at September 30, 2016 and \$470,000 and \$643,000 in residential OREO at September 30, 2016 and December 31, 2015, respectively.

Risk Grades

The following table shows the Company's loan portfolio broken down by internal risk grading as of September 30, 2016 (dollars in thousands):

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

	Commercial	Construction and Land Development	Commercial Real Estate Other	Residential	Home Equity
Pass	\$ 203,353	\$ 88,992	\$ 443,317	\$ 202,043	\$ 106,106
Special Mention	688	792	6,755	11,637	1,373
Substandard	143	1,904	4,725	4,952	1,138
Doubtful	—	—	—	—	—
Total	\$ 204,184	\$ 91,688	\$ 454,797	\$ 218,632	\$ 108,617

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

Consumer

Performing	\$ 5,249
Nonperforming	34
Total	\$ 5,283

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 Other	Residential	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

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 that 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.

## Note 5 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments as of the indicated dates and periods are presented below (dollars in thousands):

	Nine Months Ended September 30, 2016	Year Ended December 31, 2015	Nine Months Ended September 30, 2015
Allowance for Loan Losses			
Balance, beginning of period	\$ 12,601	\$ 12,427	\$ 12,427
Provision for loan losses	200	950	700
Charge-offs	(245 )	(1,200 )	(883 )
Recoveries	201	424	367
Balance, end of period	\$ 12,757	\$ 12,601	\$ 12,611

## Reserve for Unfunded Lending Commitments

Balance, beginning of period	\$ 184	\$ 163	\$ 163
Provision for unfunded commitments	11	21	26
Charge-offs	—	—	—
Balance, end of period	\$ 195	\$ 184	\$ 189

The reserve for unfunded loan commitments is included in other liabilities.

The following table presents changes in the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at and for the nine months ended September 30, 2016 (dollars in thousands):

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
Allowance for Loan Losses					
Balance at December 31, 2015:	\$ 2,065	\$ 6,930	\$ 3,546	\$ 60	\$ 12,601
Charge-offs	(40 )	—	(63 )	(142 )	(245 )
Recoveries	26	22	56	97	201
Provision for loan losses	164	39	(42 )	39	200
Balance at September 30, 2016:	\$ 2,215	\$ 6,991	\$ 3,497	\$ 54	\$ 12,757

## Balance at September 30, 2016:

## Allowance for Loan Losses

Individually evaluated for impairment	\$ —	\$ —	\$ 22	\$ —	\$ 22
Collectively evaluated for impairment	2,201	6,867	3,249	54	12,371
Acquired impaired loans	14	124	226	—	364
Total	\$ 2,215	\$ 6,991	\$ 3,497	\$ 54	\$ 12,757

## Loans

Individually evaluated for impairment	\$ 92	\$ 2,286	\$ 2,683	\$ 19	\$ 5,080
Collectively evaluated for impairment	203,588	530,892	308,654	5,248	1,048,382
Acquired impaired loans	504	13,307	15,912	16	29,739
Total	\$ 204,184	\$ 546,485	\$ 327,249	\$ 5,283	\$ 1,083,201

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

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	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 for loan losses	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 6 – Goodwill and Other Intangible Assets

The Company records as goodwill the excess of the 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 as of June 30, 2016.

Core deposit intangibles resulting from the acquisition of MidCarolina Financial Corporation ("MidCarolina") 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 in January 2015 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 nine months ended September 30, 2016, are as follows (dollars in thousands):

	Goodwill	Intangibles
Balance at December 31, 2015	\$ 43,872	\$ 2,683
Additions	—	—
Amortization	—	(789 )
Impairment	—	—
Balance at September 30, 2016	\$ 43,872	\$ 1,894

Note 7 – 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 FRB's discount window. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies or GSEs. They mature daily. The interest rates 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 of the following at September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016	December 31, 2015
Customer repurchase agreements	\$ 44,090	\$ 40,611
Other short-term borrowings	15,000	—
	\$ 59,090	\$ 40,611

Note 8 – 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 September 30, 2016, \$402,920,000 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, long-term advances as of September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016			December 31, 2015		
Due by	Advance Amount	Weighted Average Rate	Due by	Advance Amount	Weighted Average Rate	

November 30, 2017	\$ 9,974	2.98 %	November 30, 2017	\$ 9,958	2.98 %
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The advance due in November 2017 is net of a fair value discount of \$26,000. The original discount recorded on July 1, 2011, was a result of the merger with MidCarolina. The adjustment to the face value is being amortized into interest expense over the life of the borrowing. There were no long-term borrowings acquired in the MainStreet acquisition and no borrowings were incurred to fund the acquisition.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At September 30, 2016, the Bank's public deposits totaled \$150,467,000. 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 September 30, 2016, the Company had \$70,000,000 in letters of credit with the FHLB outstanding, as well as \$133,297,000 in agency, state, and municipal securities pledged to

provide collateral for such deposits.

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#### Note 9 – Junior Subordinated Debt

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a wholly owned unconsolidated subsidiary of the Company, issued \$20,000,000 of preferred securities (the "Trust 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. 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 "Junior Subordinated Debt"), issued pursuant to junior subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Junior Subordinated Debt were used to fund the cash portion of the merger consideration to the former shareholders of Community First Financial Corporation in connection with the Company's acquisition of that company in 2006, and for general corporate purposes.

On July 1, 2011, in connection with the MidCarolina merger, the Company assumed \$8,764,000 in junior subordinated debt to MidCarolina Trust I and MidCarolina Trust II, two separate Delaware statutory trusts (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 were 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 as of September 30, 2016 and December 31, 2015 (dollars in thousands):

Issuing Entity	Date Issued	Interest Rate	Maturity Date	Principal Amount	
				September 30, 2016	December 31, 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	4,251	4,209
MidCarolina Trust II	12/3/2003	Libor plus 2.95%	10/7/2033	2,828	2,794
				\$27,698	\$27,622

The principal amounts reflected above for the MidCarolina Trusts are net of fair value adjustments of \$1,685,000 and \$1,761,000 at September 30, 2016 and December 31, 2015, respectively. The original fair value adjustments of \$1,197,000 and \$1,021,000 were recorded as a result of the acquisition of MidCarolina on July 1, 2011, and are being amortized into interest expense over the remaining lives of the respective borrowings.

#### Note 10 – 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 and 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 expired 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 nine months ended September 30, 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		
Acquired in acquisition	—	—		
Granted	—	—		
Exercised	(4,134 )	24.30		
Forfeited	—	—		
Expired	—	—		
Outstanding at September 30, 2016	63,737	\$ 24.48	1.89 years	\$ 248
Exercisable at September 30, 2016	63,737	\$ 24.48	1.89 years	\$ 248

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. No stock options have been granted since 2009. As of September 30, 2016, there was no unrecognized compensation expenses related to nonvested stock option grants.

#### 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 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 the grant. Nonvested restricted stock activity for the nine months ended September 30, 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	25,943	23.07
Vested	(19,219)	21.47
Forfeited	(547 )	21.98
Nonvested at September 30, 2016	47,740	\$ 22.93

As of September 30, 2016 and December 31, 2015, there was \$585,000 and \$340,000, respectively, in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.51 years. The share based compensation expense for nonvested restricted stock was \$342,000 and \$249,000 during the first nine months of 2016 and 2015, 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 in the form of either (a) \$1,667 in cash or (b) shares of immediately vested, but restricted stock with a market value of \$2,083. Monthly meeting fees can also be received as \$725 per meeting in cash or \$900 in immediately vested, but restricted stock. For 2016, all 13 outside directors have elected to receive stock in lieu of cash for either all or part of their monthly retainer board fees. Only outside directors receive board fees. The Company issued 10,588 and 8,630 shares and recognized share based compensation expense of \$281,000 and \$195,000 during the first nine months of 2016 and 2015, 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 11 – 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. The following tables present basic and diluted earnings per share for the three and nine month periods ended September 30, 2016 and 2015.

	Three Months Ended September 30,			
	2016		2015	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	8,608,323	\$ 0.46	8,668,618	\$ 0.47
Effect of dilutive securities - stock options	10,012	—	7,953	—
Diluted earnings per share	8,618,335	\$ 0.46	8,676,571	\$ 0.47
	Nine Months Ended September 30,			
	2016		2015	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	8,610,100	\$ 1.41	8,698,394	\$ 1.20
Effect of dilutive securities - stock options	8,286	—	8,476	—
Diluted earnings per share	8,618,386	\$ 1.41	8,706,870	\$ 1.20

Outstanding stock options on common stock that were not included in computing diluted earnings per share for the nine month periods ended September 30, 2016 and 2015 because their effects were anti-dilutive, averaged 14,205 and 78,127 shares, respectively.

## Note 12 – Employee Benefit Plans

The following information for the nine months ended September 30, 2016 and 2015 pertains to the Company's non-contributory defined benefit pension plan which was frozen in 2009. If lump sum payments exceed the service cost plus interest cost, an additional settlement charge will apply (dollars in thousands):

Components of Net Periodic Benefit Cost	Nine Months Ended September 30,	
	2016	2015
Service cost	\$—	\$—
Interest cost	201	148
Expected return on plan assets	(288 )	(230 )
Recognized net actuarial loss	389	308
Net periodic cost	\$302	\$226

## Note 13 – Fair Value of Financial Instruments

### 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 820, the fair value of an 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 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 financial 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). If no observable market data is available, valuations are based upon third party model based techniques (Level 3).

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

Fair Value Measurements at September 30, 2016					
Using					
Description	Balance at September 30, 2016	Quoted	Significant	Significant	
		Prices in Active Markets for Identical Assets	Other Observable Inputs	Unobservable Inputs	
		Level 1	Level 2	Level 3	
Assets:					
Securities available for sale:					
Federal agencies and GSEs	\$96,978	\$ —	—\$ 96,978	\$ —	—
Mortgage-backed and CMOs	80,987	—	80,987	—	—
State and municipal	162,820	—	162,820	—	—
Corporate	8,820	—	8,820	—	—
Equity securities	1,834	—	1,834	—	—
Total	\$351,439	\$ —	—\$ 351,439	\$ —	—
Fair Value Measurements at December 31, 2015					
Using					
Description	Balance at December 31, 2015	Quoted	Significant	Significant	
		Prices in Active Markets for Identical Assets	Other Observable Inputs	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)					
Total Realized / Unrealized Gains (Losses) Included in					
Balances as of January 1, 2016	Net Other Comprehensive Income	Purchases, Sales, Issuances and Settlements, Net	Transfer In (Out) of Level 3	Balances as of September 30, 2016	

Securities available for sale:

Equity	\$1,486	-\$	93	\$	—	\$(1,579)	\$	—
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The Company's investment in preferred securities, a Level 3 input, was converted into common stock, a Level 1 input, at June 29, 2016.

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 nine month period ended September 30, 2016 or the year ended December 31, 2015. Gains and losses on the sale of loans are recorded within income from mortgage banking 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 the 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 comparables 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 receivable 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.

**OREO:** Measurement for fair values for OREO 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 at the dates indicated (dollars in thousands):

Description	Fair Value Measurements at September 30, 2016 Using			
	Balance at September 30, 2016	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Loans held for sale	\$4,776	\$ —	—\$ 4,776	\$ —
Impaired loans, net of valuation allowance	2,144	—	—	2,144
Other real estate owned, net	1,145	—	—	1,145
Description	Fair Value Measurements at December 31, 2015 Using			
	Balance at December 31, 2015	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Loans held for sale	\$4,776	\$ —	—\$ 4,776	\$ —
Impaired loans, net of valuation allowance	2,144	—	—	2,144
Other real estate owned, net	1,145	—	—	1,145

Description	2015	Markets Inputs 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

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The following tables summarize the Company's quantitative information about Level 3 fair value measurements at the dates indicated:

Quantitative Information About Level 3 Fair Value Measurements at September 30, 2016

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

Other real estate owned, net	Discounted appraised value	Selling cost	6 %
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Quantitative Information About Level 3 Fair Value Measurements at December 31, 2015

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

Other real estate owned, net	Discounted appraised value	Selling cost	6 %
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The carrying values and estimated fair values of the Company's financial instruments at September 30, 2016 are as follows (dollars in thousands):

Fair Value Measurements at September 30, 2016 Using

	Carrying Value	Quoted Prices in Active Markets for Identical Assets			Fair Value
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$72,817	\$72,817	\$—	\$—	\$72,817
Securities available for sale	351,439	—	351,439	—	351,439
Restricted stock	6,006	—	6,006	—	6,006
Loans held for sale	4,776	—	4,776	—	4,776
Loans, net of allowance	1,070,444	—	—	1,069,612	1,069,612
Bank owned life insurance	17,998	—	17,998	—	17,998
Accrued interest receivable	4,574	—	4,574	—	4,574
<b>Financial Liabilities:</b>					
Deposits	\$1,306,008	\$—	\$911,717	\$395,543	\$1,307,260
Repurchase agreements	44,090	—	44,090	—	44,090
Other short-term borrowings	15,000	—	—	15,000	15,000
Long-term borrowings	9,974	—	—	10,228	10,228
Junior subordinated debt	27,698	—	—	28,139	28,139
Accrued interest payable	637	—	637	—	637



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
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Carrying Value	
	Level 1	Level 2	Level 3	Balance	
<b>Financial Assets:</b>					
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
<b>Financial Liabilities:</b>					
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 a reasonable estimate of 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 values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

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 fair values of other borrowings are estimated using discounted cash flow analysis based on the interest rates for similar types of borrowing arrangements.



Long-term borrowings. The fair values of other 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 September 30, 2016 and December 31, 2015, the fair value of off-balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

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 14 – 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 includes activities of the Company which are primarily debt service on trust preferred securities and corporate items.

Segment information as of and for the three and nine months ended September 30, 2016 and 2015 (unaudited), is shown in the following tables (dollars in thousands):

	Three Months Ended September 30, 2016				Total
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	
Interest income	\$ 14,040	\$ —	—\$ 23	\$ —	\$ 14,063
Interest expense	1,376	—	223	—	1,599
Noninterest income	1,967	1,147	6	—	3,120
Income (loss) before income taxes	5,356	672	(411 )	—	5,617
Net income (loss)	3,760	474	(271 )	—	3,963
Depreciation and amortization	671	2	—	—	673
Total assets	1,611,624	—	231,496	(227,586)	1,615,534
Goodwill	43,872	—	—	—	43,872
Capital expenditures	267	—	—	—	267

## Three Months Ended September 30, 2015

	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$13,527	\$ —	—\$ 15	\$ —	\$ 13,542
Interest expense	1,290	—	191	—	1,481
Noninterest income	1,788	1,262	5	—	3,055
Income (loss) before income taxes	5,160	803	(235 )	—	5,728
Net income (loss)	3,626	566	(155 )	—	4,037
Depreciation and amortization	772	3	—	—	775
Total assets	1,510,324	—	224,120	(222,007)	1,512,437
Goodwill	44,333	—	—	—	44,333
Capital expenditures	602	—	—	—	602

## Nine Months Ended September 30, 2016

	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$41,950	\$ —	—\$ 53	\$ —	\$ 42,003
Interest expense	4,151	—	644	—	4,795
Noninterest income	6,302	3,465	17	—	9,784
Income (loss) before income taxes	16,538	2,006	(1,193)	—	17,351
Net income (loss)	11,558	1,408	(787 )	—	12,179
Depreciation and amortization	2,190	8	—	—	2,198
Total assets	1,611,624	—	231,496	(227,586)	1,615,534
Goodwill	43,872	—	—	—	43,872
Capital expenditures	536	—	—	—	536

## Nine Months Ended September 30, 2015

	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$41,173	\$ —	—\$ 45	\$ —	\$ 41,218
Interest expense	3,834	—	563	—	4,397
Noninterest income	5,809	3,645	15	—	9,469
Income (loss) before income taxes	13,314	2,026	(827 )	—	14,513
Net income (loss)	9,522	1,456	(546 )	—	10,432
Depreciation and amortization	2,249	9	—	—	2,258
Total assets	1,510,324	—	224,120	(222,007)	1,512,437
Goodwill	44,333	—	—	—	44,333
Capital expenditures	1,182	21	—	—	1,203

## Note 15 – Supplemental Cash Flow Information

	Nine Months Ended September 30, 2016    2015	
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$37,679	\$19,280
Interest-bearing deposits in other banks	35,138	46,637
Federal funds sold	—	—
Cash and Cash Equivalents	\$72,817	\$65,917
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	\$4,813	\$4,341
Income taxes	5,440	2,950
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	97	1,094
Unrealized gains (losses) on securities available for sale	720	(582 )
Non-cash transactions related to acquisitions:		
Assets acquired:		
Investment securities	—	18,800
Restricted stock	—	587
Loans	—	115,050
Premises and equipment	—	1,030
Deferred income taxes	—	2,773
Core deposit intangible	—	1,839
Other real estate owned	—	168
Bank owned life insurance	—	1,955
Other assets	—	1,077
Liabilities assumed:		
Deposits	—	137,323
Other liabilities	—	3,001
Consideration:		
Issuance of common stock	—	20,483

## Note 16 – Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income ("AOCI") for the three and nine months ended September 30, 2016 and 2015 (unaudited) were as follows (dollars in thousands):

For the Three Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at June 30, 2015	\$ 4,583	\$ (2,181 )	\$ 2,402
Net unrealized gains on securities available for sale, net of tax, \$(478)	887	—	887
Reclassification adjustment for gains on sales of securities, net of tax, \$3	(3 )	—	(3 )
Balance at September 30, 2015	\$ 5,467	\$ (2,181 )	\$ 3,286
Balance at June 30, 2016	\$ 5,563	\$ (1,832 )	\$ 3,731
Net unrealized losses on securities available for sale, net of tax, \$499	(925 )	—	(925 )
Reclassification adjustment for gains on sales of securities, net of tax, \$25	(48 )	—	(48 )
Balance at September 30, 2016	\$ 4,590	\$ (1,832 )	\$ 2,758
Nine Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2014	\$ 5,845	\$ (2,181 )	\$ 3,664
Net unrealized losses on securities available for sale, net of tax, \$10	(19 )	—	(19 )
Reclassification adjustment for gains on sales of securities, net of tax, \$194	(359 )	—	(359 )
Balance at September 30, 2015	\$ 5,467	\$ (2,181 )	\$ 3,286
Balance at December 31, 2015	\$ 4,122	\$ (1,832 )	\$ 2,290
Net unrealized gains on securities available for sale, net of tax, \$(483)	898	—	898
Reclassification adjustment for gains on sales of securities, net of tax, \$231	(430 )	—	(430 )
Balance at September 30, 2016	\$ 4,590	\$ (1,832 )	\$ 2,758



Reclassifications Out of Accumulated Other Comprehensive Income  
 For the three and nine months ended September 30, 2016 and 2015  
 (dollars in thousands)

For the Three Months Ended September 30, 2016	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
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Details about AOCI Components

Available for sale securities:

Realized gain on sale of securities	\$ 73	Securities gains, net
	(25 )	Income taxes
Total reclassifications	\$ 48	Net of tax

For the Three Months Ended September 30, 2015	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
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Details about AOCI Components

Available for sale securities:

Realized gain on sale of securities	\$ 6	Securities gains, net
	(3 )	Income taxes
Total reclassifications	\$ 3	Net of tax

For the Nine Months Ended September 30, 2016	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
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Details about AOCI Components

Available for sale securities:

Realized gain on sale of securities	\$ 661	Securities gains, net
	(231 )	Income taxes
Total reclassifications	\$ 430	Net of tax

For the Nine Months Ended September 30, 2015	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
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Details about AOCI Components

Available for sale securities:

Realized gain on sale of securities	\$ 553	Securities gains, net
	(194 )	Income taxes
Total reclassifications	\$ 359	Net of tax

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on important factors affecting the financial condition and results of operations of the Company. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements.

### 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 of the Company's Annual Report on Form 10-K for the year ended December 31, 2015, 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 and other acquisitions and other expansion activities.

### Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2015 presentation. There were no material reclassifications.

### CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("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 and (4) goodwill impairment. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements contained in the Form 10-K for the year ended December 31, 2015.

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, (6) regular meetings of the Credit

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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, Risk and Compliance 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, 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 sizable 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 Impairment

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 nine months ended September 30, 2016 or 2015.

#### 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 impact to net interest income and pretax income from accretable and amortizable fair value adjustments attributable to the merger with MidCarolina Financial Corporation ("MidCarolina") in July 2011 and the merger with MainStreet BankShares, Inc. ("MainStreet") in January 2015.

#### Internet Access to Corporate Documents

The Company provides access to its Securities and Exchange Commission ("SEC") filings through a link on the Investor Relations page of the Company's web site at [www.amnb.com](http://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](http://www.sec.gov).

#### STRATEGIC EVENT

The Company announced in September 2016 its plan to form a de novo branch in each of Roanoke, Virginia, and Winston-Salem, North Carolina. Initial staffing for Roanoke includes seven lenders and one credit analyst. Initial staffing for Winston-Salem includes three lenders and one portfolio manager. Employee additions for Roanoke were made in the late third quarter and had only a limited impact on the financials during the quarter. Employee additions for Winston-Salem were made during the fourth quarter and had no impact on quarterly results.

It is expected that the de novo efforts will have a material and positive impact to the Company's balance sheet, especially over the next five quarters.

## RESULTS OF OPERATIONS

## Earnings Performance

Three months ended September 30, 2016 and 2015

For the quarter ended September 30, 2016, the Company reported net income of \$3,963,000 compared to \$4,037,000 for the comparable quarter in 2015. The \$74,000 or 1.8% decrease was primarily due to increased salaries expense related to the startup costs for the de novo branch in Roanoke.

## SUMMARY INCOME STATEMENT

(Dollars in thousands)

Three Months Ended September 30, 2016	2015	\$	%
		Change	Change
Interest income	\$ 14,063	\$ 13,542	\$ 521 3.8 %
Interest expense	(1,599 )	(1,481 )	(118 ) 8.0
Net interest income	12,464	12,061	403 3.3
Provision for loan losses	(100 )	—	(100 ) 100.0
Noninterest income	3,120	3,055	65 2.1
Noninterest expense	(9,867 )	(9,388 )	(479 ) 5.1
Income tax expense	(1,654 )	(1,691 )	37 (2.2 )
Net income	\$3,963	\$4,037	\$ (74 ) (1.8 )

Nine months Ended September 30, 2016 and 2015

For the nine month period ended September 30, 2016, the Company reported net income of \$12,179,000 compared to \$10,432,000 for the comparable period in 2015. The \$1,747,000 or 16.7% increase in earnings was primarily related to non-recurring MainStreet acquisition expenses, which totaled \$1,948,000 for the same period of 2015.

## SUMMARY INCOME STATEMENT

(Dollars in thousands)

Nine months Ended September 30, 2016	2015	\$	%
		Change	Change
Interest income	\$42,003	\$41,218	\$785 1.9 %
Interest expense	(4,795 )	(4,397 )	(398 ) 9.1
Net interest income	37,208	36,821	387 1.1
Provision for loan losses	(200 )	(700 )	500 (71.4)
Noninterest income	9,784	9,469	315 3.3
Noninterest expense	(29,441 )	(31,077 )	1,636 (5.3 )
Income tax expense	(5,172 )	(4,081 )	(1,091 ) 26.7
Net income	\$12,179	\$10,432	\$1,747 16.7

## 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 and other funding sources. 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 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.





Three months ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis increased \$361,000 or 2.9%, for the third quarter of 2016 compared to the same quarter of 2015. The increase was primarily due to increased loan volume in the 2016 quarter compared to the 2015 quarter.

For the third quarter of 2016, the Company's yield on interest-earning assets was 3.93%, compared to 4.06% for the third quarter of 2015. The cost of interest-bearing liabilities was 0.60% compared to 0.58%, primarily related to a four basis point increase in the cost of time deposits. The interest rate spread was 3.33% compared to 3.48%. The net interest margin, on a fully taxable equivalent basis, was 3.50% compared to 3.64%, a decrease of fourteen basis points (0.14%). The decrease in net interest margin was driven by lower yields on earning assets and reduced levels of accretion income.

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The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended September 30, 2016 and 2015. 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.

Net Interest Income Analysis (in thousands, except rates)  
Three Months Ended September 30,

	Average Balance		Income/Expense		Yield/Rate	
	2016	2015	2016	2015	2016	2015
<b>Loans:</b>						
Commercial	\$200,448	\$164,551	\$2,022	\$1,801	4.01 %	4.34 %
Real estate	862,740	814,500	9,939	9,557	4.61	4.69
Consumer	5,179	6,034	136	150	10.45	9.86
Total loans	1,068,367	985,085	12,097	11,508	4.52	4.67
<b>Securities:</b>						
Federal agencies & GSEs	99,375	103,303	428	431	1.72	1.67
Mortgage-backed & CMOs	81,945	57,100	411	282	2.01	1.98
State and municipal	158,010	180,799	1,370	1,650	3.47	3.65
Other	15,450	16,225	132	140	3.42	3.45
Total securities	354,780	357,427	2,341	2,503	2.64	2.80
Federal funds sold	—	76	—	1	—	5.22
Deposits in other banks	54,061	37,988	78	25	0.57	0.26
Total interest-earning assets	1,477,208	1,380,576	14,516	14,037	3.93	4.06
Non-earning assets	128,179	130,888				
Total assets	\$1,605,387	\$1,511,464				
<b>Deposits:</b>						
Demand	\$200,469	\$221,700	10	20	0.02	0.04
Money market	253,269	191,689	118	63	0.19	0.13
Savings	117,737	109,919	9	13	0.03	0.05
Time	401,956	400,532	1,154	1,109	1.14	1.10
Total deposits	973,431	923,840	1,291	1,205	0.53	0.52
Customer repurchase agreements	50,013	45,444	1	2	0.01	0.02
Other short-term borrowings	1,521	57	3	—	0.79	0.35
Long-term borrowings	37,655	37,531	304	274	3.23	2.92
Total interest-bearing liabilities	1,062,620	1,006,872	1,599	1,481	0.60	0.58
Noninterest bearing demand deposits	328,443	299,488				
Other liabilities	10,873	9,444				
Shareholders' equity	203,451	195,660				
Total liabilities and shareholders' equity	\$1,605,387	\$1,511,464				

Interest rate spread	3.33 %	3.48 %
Net interest margin	3.50 %	3.64 %
Net interest income (taxable equivalent basis)	12,917	12,556
Less: Taxable equivalent adjustment	453	495
Net interest income	\$12,464	\$12,061

## Changes in Net Interest Income (Rate/Volume Analysis)

(in thousands)

	Three Months Ended		
	September 30, 2016 vs. 2015		
	Change		
	Increase	Attributable to	
	(Decrease)	Rate	Volume
Interest income			
Loans:			
Commercial	\$221	\$(149)	\$ 370
Real estate	382	(176 )	558
Consumer	(14 )	8	(22 )
Total loans	589	(317 )	906
Securities:			
Federal agencies	(3 )	14	(17 )
Mortgage-backed	129	4	125
State and municipal	(280 )	(79 )	(201 )
Other securities	(8 )	(1 )	(7 )
Total securities	(162 )	(62 )	(100 )
Federal funds sold	(1 )	(1 )	—
Deposits in other banks	53	39	14
Total interest income	479	(341 )	820
Interest expense			
Deposits:			
Demand	(10 )	(8 )	(2 )
Money market	55	31	24
Savings	(4 )	(5 )	1
Time	45	41	4
Total deposits	86	59	27
Customer repurchase agreements	(1 )	(1 )	—
Other short-term borrowings	3	3	—
Other borrowings	30	29	1
Total interest expense	118	90	28
Net interest income (taxable equivalent basis)	\$361	\$(431)	\$ 792

## Nine months Ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis increased \$274,000 or 0.71%, for the nine months ended September 30, 2016 compared to the same period of 2015. This change was positively impacted by increased average loans during the 2016 period.

For the first nine months of 2016, the Company's yield on interest-earning assets was 3.98%, compared to 4.11% for the same period of 2015. The cost of interest-bearing liabilities was 0.61% compared to 0.57%, mostly related to an eight basis point increase in the cost of time deposits. The interest rate spread was 3.37% compared to 3.54%. The net interest margin, on a fully taxable equivalent basis, was 3.54% compared to 3.69%, a decrease of fifteen basis points (0.15%).

Net interest income for the first nine months of 2016 and 2015 was positively impacted by increased loan volume. For the 2016 period, acquisition related accretion income was \$1,709,000 or 4.6% of total net interest income. For the 2015 period, acquisition related accretion income was \$2,503,000 or 6.8% of net interest income.



The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the nine months ended September 30, 2016 and 2015. 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.

Net Interest Income Analysis (in thousands, except rates)  
Nine Months Ended September 30,

	Average Balance		Income/Expense		Yield/Rate	
	2016	2015	2016	2015	2016	2015
<b>Loans:</b>						
Commercial	\$196,256	\$153,234	\$5,852	\$5,387	3.98 %	4.70%
Real estate	844,276	807,875	29,620	29,117	4.68	4.81
Consumer	5,283	10,940	507	595	12.82	7.27
Total loans	1,045,815	972,049	35,979	35,099	4.59	4.82
<b>Securities:</b>						
Federal agencies & GSEs	95,967	88,427	1,252	1,000	1.74	1.51
Mortgage-backed & CMOs	79,746	61,434	1,235	994	2.06	2.16
State and municipal	162,885	185,587	4,336	5,133	3.55	3.69
Other	15,689	15,383	410	388	3.48	3.36
Total securities	354,287	350,831	7,233	7,515	2.72	2.86
Federal funds sold	—	6,992	—	6	—	0.11
Deposits in other banks	55,454	56,842	203	123	0.49	0.29
Total interest-earning assets	1,455,556	1,386,714	43,415	42,743	3.98	4.11
Non-earning assets	127,450	133,521				
Total assets	\$1,583,006	\$1,520,235				
<b>Deposits:</b>						
Demand	\$220,419	\$223,858	90	60	0.05	0.04
Money market	226,780	196,693	284	195	0.17	0.13
Savings	117,599	109,008	37	39	0.04	0.05
Time	400,593	406,334	3,491	3,289	1.16	1.08
Total deposits	965,391	935,893	3,902	3,583	0.54	0.51
Customer repurchase agreements	47,353	49,985	3	7	0.01	0.02
Other short-term borrowings	512	19	3	—	0.78	0.35
Long-term borrowings	37,624	37,500	887	807	3.14	2.87
Total interest-bearing liabilities	1,050,880	1,023,397	4,795	4,397	0.61	0.57
Noninterest bearing demand deposits	320,643	291,112				
Other liabilities	9,923	9,591				
Shareholders' equity	201,560	196,135				
Total liabilities and shareholders' equity	\$1,583,006	\$1,520,235				

Interest rate spread		3.37	%	3.54	%
Net interest margin		3.54	%	3.69	%
Net interest income (taxable equivalent basis)	38,620	38,346			
Less: Taxable equivalent adjustment	1,412	1,525			
Net interest income	\$37,208	\$36,821			

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## Changes in Net Interest Income (Rate/Volume Analysis)

(in thousands)

	Nine Months Ended September 30, 2016 vs. 2015		
	Change		
	Increase (Decrease)	Attributable to Rate	Volume
Interest income			
Loans:			
Commercial	\$465	\$(898)	\$1,363
Real estate	503	(787)	1,290
Consumer	(88)	315	(403)
Total loans	880	(1,370)	2,250
Securities:			
Federal agencies	252	162	90
Mortgage-backed	241	(44)	285
State and municipal	(797)	(187)	(610)
Other securities	22	14	8
Total securities	(282)	(55)	(227)
Federal funds sold	(6)	(3)	(3)
Deposits in other banks	80	83	(3)
Total interest income	672	(1,345)	2,017
Interest expense			
Deposits:			
Demand	30	31	(1)
Money market	89	56	33
Savings	(2)	(5)	3
Time	202	249	(47)
Total deposits	319	331	(12)
Customer repurchase agreements	(4)	(4)	—
Other short-term borrowings	3	3	—
Other borrowings	80	77	3
Total interest expense	398	407	(9)
Net interest income (taxable equivalent basis)	\$274	\$(1,752)	\$2,026



## Noninterest Income, three months ended September 30, 2016 and 2015

For the quarter ended September 30, 2016, noninterest income increased \$65,000 or 2.1% compared to the comparable 2015 quarter. Details of individual accounts are shown in the table below.

	Three Months Ended September 30, (Dollars in thousands)			
	2016	2015	\$ Change	% Change
Noninterest income:				
Trust fees	\$938	\$1,006	\$ (68 )	(6.8 )%
Service charges on deposit accounts	514	521	(7 )	(1.3 )
Other fees and commissions	663	592	71	12.0
Mortgage banking income	512	376	136	36.2
Securities gains, net	73	6	67	1,116.7
Brokerage fees	209	255	(46 )	(18.0 )
Income from Small Business Investment Companies (SBICs)	—	99	(99 )	(100.0 )
Other	211	200	11	5.5
Total noninterest income	\$3,120	\$3,055	\$ 65	2.1

Trust income decreased slightly due to volatility in the equity markets. Service charge income was virtually unchanged for the 2016 quarter compared to the 2015 quarter. Other fees and commissions were positively impacted by higher levels of debit card transaction volume. Mortgage banking income increased significantly in the 2016 quarter as a result of increases in the volume of originations. Net securities gains increased in the 2016 quarter as a result of called securities. Income from Small Business Investment Companies ("SBICs") reflected a \$99,000 decrease compared to the 2015 quarter; this category of income is highly unpredictable.

## Noninterest Income, nine months ended September 30, 2016 and 2015

For the nine months ended September 30, 2016, noninterest income increased \$315,000 or 3.3% compared to the comparable 2015 period. Details of individual accounts are shown in the table below.

	Nine Months Ended September 30, (Dollars in thousands)			
	2016	2015	\$ Change	% Change
Noninterest income:				
Trust fees	\$2,829	\$2,963	\$ (134 )	(4.5 )%
Service charges on deposit accounts	1,520	1,543	(23 )	(1.5 )
Other fees and commissions	1,991	1,787	204	11.4
Mortgage banking income	1,169	987	182	18.4
Securities gains, net	661	553	108	19.5
Brokerage fees	636	681	(45 )	(6.6 )
Income from Small Business Investment Companies (SBICs)	238	427	(189 )	(44.3)
Other	740	528	212	40.2
Total noninterest income	\$9,784	\$9,469	\$ 315	3.3

Trust income decreased for the 2016 period compared to the 2015 period primarily due to volatility early in the year in the equity markets. Other fees and commissions were positively impacted by higher levels of debit card transaction volume. Mortgage banking income was higher in the 2016 period, based on greater loan demand in existing markets and the impact of the MainStreet acquisition. Net securities gains increased in the 2016 period as a result of gains from called securities. Income from SBICs reflected a \$189,000 decrease compared to the 2015 period; this category of income is highly unpredictable. Other income increased \$212,000 compared to the 2015 period primarily due to the additional income from investments in limited partnerships during the nine months ended September 30, 2016.

Noninterest Expense, three months ended September 30, 2016 and 2015

For the three months ended September 30, 2016, noninterest expense increased \$479,000 or 5.1%. Details of individual accounts are shown in the table below.

	Three Months Ended September 30,			
	(Dollars in thousands)			
	2016	2015	\$ Change	% Change
Noninterest Expense				
Salaries	\$4,626	\$4,179	\$ 447	10.7 %
Employee benefits	1,034	1,029	5	0.5
Occupancy and equipment	1,004	1,094	(90 )	(8.2 )
FDIC assessment	138	185	(47 )	(25.4 )
Bank franchise tax	257	220	37	16.8
Core deposit intangible amortization	213	300	(87 )	(29.0 )
Data processing	437	366	71	19.4
Software	301	290	11	3.8
Other real estate owned, net	105	(126 )	231	(183.3)
Merger related expenses	—	87	(87 )	(100.0)
Other	1,752	1,764	(12 )	(0.7 )
Total noninterest expense	\$9,867	\$9,388	\$ 479	5.1

Salaries expense increased in the 2016 quarter as compared to 2015 quarter as a result of additional compensation expenses relate to the de novo branch start-up in Roanoke and Winston-Salem. Approximately \$200,000 of the increase was related to the de novo branches, of which \$150,000 were nonrecurring payments. Full time equivalent employees at the end of the 2016 quarter were 309, down from 310 for the prior year; the additional employees for the de novo branches were added at the end of the quarter. Other real estate owned expenses increased in 2016 compared to 2015. The 2015 quarter reflected a gain on the sale of one foreclosed property in the amount of \$183,000.

## Noninterest Expense, nine months ended September 30, 2016 and 2015

For the nine months ended September 30, 2016, noninterest expense decreased \$1,636,000 or 5.3%. Details of individual accounts are shown in the table below.

	Nine months Ended September 30, (Dollars in thousands)			
	2016	2015	\$ Change	% Change
Noninterest Expense				
Salaries	\$12,872	\$12,634	\$238	1.9 %
Employee benefits	3,203	3,215	(12 )	(0.4 )
Occupancy and equipment	3,162	3,290	(128 )	(3.9 )
FDIC assessment	519	565	(46 )	(8.1 )
Bank franchise tax	769	675	94	13.9
Core deposit intangible amortization	789	901	(112 )	(12.4 )
Data processing	1,340	1,311	29	2.2
Software	872	850	22	2.6
Other real estate owned, net	314	60	254	423.3
Merger related expenses	—	1,948	(1,948 )	(100.0)
Other	5,601	5,628	(27 )	(0.5 )
Total noninterest expense	\$29,441	\$31,077	\$(1,636)	(5.3 )

Salaries increased in the 2016 period as compared to the 2015 period primarily related to the additional compensation expenses of the de novo branch. Approximately \$200,000 of the increase was related to the de novo, of which \$150,000 were nonrecurring payments. The change in other real estate owned expenses during the 2016 period was primarily a result of the gain on the sale of one foreclosed property in the amount of \$183,000 during the 2015 period. The largest component of the decrease in expense was the 2015 nonrecurring merger related expenses of \$1.9 million, which was the primary change in the overall reduction.

Non-GAAP Financial Measures

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 the 2016 and 2015 quarters was 61.25%. The Company expects continued improvement in this ratio in coming quarters. 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):

	Three Months Ended	
	September 30,	
	2016	2015
Efficiency Ratio		
Noninterest expense	\$9,867	\$9,388
Add/Subtract: loss/(gain) on sale OREO	(88 )	166
	\$9,779	\$9,554
Net interest income	\$12,464	\$12,061
Tax equivalent adjustment	453	495
Noninterest income	3,120	3,055
Subtract: gain on securities	(73 )	(6 )
Add/Subtract: (gain)/loss on sale of fixed assets	1	(6 )
	\$15,965	\$15,599
Efficiency ratio	61.25 %	61.25 %

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 both 2016 and 2015 quarters 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):

	Three Months Ended September 30,	
	2016	2015
Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income		
Non-GAAP measures:		
Interest income - loans	\$ 12,097	\$ 11,508
Interest income - investments and other	2,419	2,529
Interest expense - deposits	(1,291 )	(1,205 )
Interest expense - other borrowings	(1 )	(2 )

Interest expense - other short-term borrowings	(3	)	—	)
Interest expense - junior subordinated debt	(304	)	(274	)
Total net interest income	\$	12,917	\$	12,556
Less non-GAAP measures:				
Tax benefit realized on non-taxable interest income - loans	\$	(64	)	\$ (34
Tax benefit realized on non-taxable interest income - municipal securities	(389	)	(461	)
GAAP measures	\$	12,464	\$	12,061

## Income Taxes

The effective tax rate for the third quarter of 2016 was 29.45% compared to 29.52% for the third quarter of 2015. 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 effective tax rate for the first nine months of 2016 was 29.81% compared to 28.12% for the same period of 2015. The increase in the effective tax rate of 1.69% is primarily related to a lower level of tax exempt municipal securities income.

## Fair Value Impact to Net Income

The following table presents the impact for the three and nine month periods ended September 30, 2016 of the accretible and amortizable fair value adjustments attributable to the July 2011 acquisition of MidCarolina and the January 2015 acquisition of MainStreet on net interest income and pretax income (dollars in thousands):

		September 30, 2016			
Income Statement Effect		Premium (Discount) Balance on December 31, 2015	Three Months Ended	Nine Months Ended	Remaining Premium (Discount) Balance
Interest income/(expense):					
Acquired performing loans	Income	\$ (3,061 )	\$ 250	\$ 723	\$ (2,338 )
Purchase acquired impaired loans	Income	(7,066 )	137	1,079	(5,987 )
FHLB advances	Expense	42	(6 )	(17 )	25
Junior subordinated debt	Expense	1,761	(25 )	(76 )	1,685
Net interest income			356	1,709	
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 2,683	(213 )	(789 )	\$ 1,894
Net non-interest expense			(213 )	(789 )	
Change in pretax income			\$ 143	\$ 920	

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The following table presents the impact for the three and nine month periods ended September 30, 2015 of the accretable and amortizable fair value adjustments attributable to the two acquisitions mentioned above on net interest income and pretax income (dollars in thousands):

	Income Statement Effect	September 30, 2015				
		Premium (Discount) Balance on December 31, 2014	Additions	Three Months Ended	Nine Months Ended	Remaining Premium (Discount) Balance
<b>Interest income/(expense):</b>						
Acquired performing loans	Income	\$ (3,358 )	\$(4,270)	\$ 456	\$ 2,170	\$ (5,458 )
Purchase acquired impaired loans	Income	(1,440 )	(1,208 )	51	211	(2,437 )
FHLB Advances	Expense	65	—	(5 )	(17 )	48
Junior subordinated debt	Expense	1,862	—	(26 )	(77 )	1,785
CD valuation	Expense	—	(288 )	72	216	(72 )
Brokered CD valuation	Expense	—	(2 )	—	—	(2 )
Net interest income			(5,768 )	548	2,503	
<b>Non-interest (expense)</b>						
Amortization of core deposit intangible	Expense	\$ 2,045	1,839	(300 )	\$(901 )	\$ 2,983
Net non-interest expense			1,839	(300 )	(901 )	
Change in pretax income			\$(3,929)	\$ 248	\$ 1,602	

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 a potentially significant impact to net interest income and to net income.

The table below summarizes the impact of the fair value acquisition related accounting adjustments on net interest income and total pretax income of the MidCarolina ("MC" for the table below only) and MainStreet ("MS" for the table below only) acquisitions for the three and nine month periods indicated (dollars in thousands):

	Three Months Ended September 30, 2016			2015		
	MC	MS	Total	MC	MS	Total
Net interest income	\$192	\$164	\$356	\$205	343	\$548
Core deposit amortization	(151 )	(62 )	(213 )	(227 )	(73 )	(300 )
Total pretax income	\$41	\$102	\$143	\$(22 )	270	\$248
<b>Nine Months Ended September 30, 2016</b>						
	MC	MS	Total	MC	MS	Total
Net interest income	\$1,061	\$648	\$1,709	\$1,141	1,362	\$2,503
Core deposit amortization	(604 )	(185 )	(789 )	(681 )	(220 )	(901 )
Total pretax income	\$457	\$463	\$920	\$460	1,142	\$1,602

The MidCarolina acquisition was effective July 1, 2011 and the MainStreet acquisition was effective January 1, 2015. Management expects that the acquisition accounting financial impact of these acquisitions will continue to decline in future 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 expense, which tends 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. During the reported periods, inflation and interest rates have been low.

## CHANGES IN FINANCIAL POSITION

### BALANCE SHEET ANALYSIS

#### Securities

The securities portfolio generates income, plays a major role in the management of interest rate sensitivity, provides a source of liquidity, is used to meet collateral requirements for public deposits, and facilitates commercial customers' repurchase agreements. The portfolio consists primarily of high credit quality, very liquid securities. Federal agency and U. S. government sponsored enterprises, mortgage-backed securities, state and municipal securities, and corporates comprise the portfolio.

The available for sale securities portfolio was \$351,439,000 at September 30, 2016, compared to \$340,349,000 at December 31, 2015, an increase of \$11,090,000 or 3.26%. At September 30, 2016, the available for sale portfolio had an amortized cost of \$344,378,000 resulting in a net unrealized gain of \$7,061,000. At December 31, 2015, the available for sale portfolio had an amortized cost of \$334,008,000, resulting in a net unrealized gain of \$6,341,000. 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 manages its investment portfolio on an aggregate portfolio basis for purposes of monitoring and controlling average life and duration. Accordingly, some individual purchases may fall outside these overall guidelines. The Company will continue to deploy its cash to the maximum extent practical and prudent, consistent with its liquidity and asset liability strategies, and regulatory requirements.

#### 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.

Total loans were \$1,083,201,000 at September 30, 2016, compared to \$1,005,525,000 at December 31, 2015, an increase of \$77,676,000 or 7.72%. The increase is a result of organic growth resulting from improving economic conditions and business development efforts in the Bank's markets.

In addition, recently announced plans for establishing a de novo branch in each of Roanoke and in Winston-Salem are expected to have a material and positive impact on loan growth over the next several quarters.

Loans held for sale totaled \$4,776,000 at September 30, 2016 and \$3,266,000 at December 31, 2015. Loan production volume was \$53,870,000 for the nine month period ending September 30, 2016 and \$59,030,000 for the year ended December 31, 2015. These loans were approximately 60% purchase and 40% refinancing.

Management of the loan portfolio is organized around classes. Each class is comprised of various loan types that are reflective of operational and regulatory management and reporting requirements. The following table presents the Company's loan portfolio by class as of September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016	December 31, 2015
Commercial	\$204,184	\$177,481
Commercial real estate:		
Construction and land development	91,688	72,968
Commercial real estate	454,797	430,186
Residential real estate:		
Residential	218,632	220,434
Home equity	108,617	98,449
Consumer	5,283	6,007
Total loans	\$1,083,201	\$1,005,525

#### Provision for Loan Losses

Provision for loan losses was \$200,000 for the nine month period ended September 30, 2016, compared to \$700,000 for the same period ended September 30, 2015. The need for additional provision in the nine month period ended September 30, 2016 was mitigated by improvement in various qualitative factors used in the determination of the allowance, notably asset quality and local economic conditions. Provision expense in the 2015 period was unusually large as a result of the quarterly review of expected cash flows from certain purchased credit impaired loans.

#### Allowance for Loan Losses ("ALLL")

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.

At September 30, 2016, the ALLL was \$12,757,000 compared to \$12,601,000 at December 31, 2015. The ALLL as a percentage of total loans was 1.18% and 1.25%, respectively.

As part of the Company's methodology to evaluate the adequacy of its ALLL, the Company computes its ASC 450 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. The FASB ASC 450 loan loss reserve balance is the total ALLL reduced by allowances associated with these other pools of loans.

The general allowance, ASC 450 (FAS 5) reserves to FASB ASC 450 loans, was 1.27% at September 30, 2016, compared to 1.40% at December 31, 2015. On a dollar basis, the reserve was \$12,371,000 at September 30, 2016, compared to \$12,159,000 at December 31, 2015. The percentage of the reserve to total loans has declined due to improving local economic conditions and continued improvement in asset quality as evidenced by reductions in substandard loans, special mention loans, nonaccrual loans and past due loans. 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 FASB ASC 310-40 loans, was 0.44% at September 30, 2016, compared to 0.74% at December 31, 2015. On a dollar basis, the reserve was \$22,000 at September 30, 2016, compared to \$35,000 at December 31, 2015. There is ongoing turnover in the composition of the impaired loan population, which increased by a net \$373,000 over December 31, 2015. Newly evaluated impaired loans did not have a significant impact on the overall impairment allowance.

The specific allowance does not include reserves related to acquired loans with deteriorated credit quality. This reserve was \$364,000 at September 30, 2016 compared to \$407,000 at December 31, 2015. This is the only portion of the reserve related to acquired impaired 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 additional loan loss provision. The decrease in this impairment for the current period is related to the recasting of expected cash flows during the quarter, which utilized lifetime default probabilities and loss given default estimates. This recast also incorporated an upward migration in risk grades for loans in the acquired impaired portfolio. The following table presents the Company's loan loss and recovery experience for the periods indicated (dollars in thousands):

## Summary of Loan Loss Experience

	Nine Months Ended September 30, 2016	Year Ended December 31, 2015
Balance at beginning of period	\$ 12,601	\$ 12,427
Charge-offs:		
Construction and land development	—	20
Commercial real estate	—	462
Residential real estate	—	15
Home equity	63	308
Total real estate	63	805
Commercial and industrial	40	175
Consumer	142	220
Total charge-offs	245	1,200
Recoveries:		
Construction and land development	7	81
Commercial real estate	15	43
Residential real estate	44	121
Home equity	12	18
Total real estate	78	263
Commercial and industrial	26	32
Consumer	97	129
Total recoveries	201	424
Net charge-offs (recoveries)	44	776
Provision for loan losses	200	950
Balance at end of period	\$ 12,757	\$ 12,601

## Asset Quality Indicators

The following table provides qualitative indicators relevant to the Company's loan portfolio for the nine month period and year indicated below.

## Asset Quality Ratios

	September 30, 2016		December 31, 2015	
Allowance to loans	1.18	%	1.25	%
ASC 450 (FAS 5) ALLL	1.27		1.40	
Net charge-offs (recoveries) to allowance (1)	0.46		6.16	
Net charge-offs (recoveries) to average loans (1)	0.01		0.08	
Nonperforming assets to total assets	0.31		0.48	
Nonperforming loans to loans	0.36		0.52	
Provision to net charge-offs (recoveries) (1)	454.55		122.42	
Provision to average loans (1)	0.03		0.10	
Allowance to nonperforming loans	331.70		242.09	

(1) - annualized.

## 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 0.36% at September 30, 2016 and 0.52% at December 31, 2015.

Nonperforming assets include nonperforming loans and OREO. Nonperforming assets represented 0.31% of total assets at September 30, 2016, down from 0.48% at December 31, 2015. This decrease was related primarily to the decreases in OREO and net charge-offs.

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.

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 assets as of September 30, 2016 and December 31, 2015 (dollars in thousands):

Nonperforming Assets

	September 30, 2016	December 31, 2015
Nonaccrual loans:		
Real estate	\$ 3,770	\$ 5,106
Commercial	67	90
Consumer	9	9
Total nonaccrual loans	3,846	5,205
Loans past due 90 days and accruing interest:	—	—
Total nonperforming loans	3,846	5,205
Other real estate owned	1,145	2,184
Total nonperforming assets	\$ 4,991	\$ 7,389

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 September 30, 2016 and December 31, 2015 (dollars in thousands):

Impaired Loans

	September 30, 2016	December 31, 2015
Accruing	\$ 1,741	\$ 1,171
Nonaccruing	3,339	3,536
Total impaired loans	\$ 5,080	\$ 4,707

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 \$2,527,000 in TDRs at September 30, 2016 compared to \$1,958,000 at December 31, 2015. These loans are included in the impaired loan table above.

### Other Real Estate Owned

Other real estate owned was \$1,145,000 and \$2,184,000 as of September 30, 2016 and December 31, 2015, respectively. OREO is 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 the Company's OREO as of September 30, 2016 and December 31, 2015 (dollars in thousands):

#### Other Real Estate Owned

	September 30, 2016	December 31, 2015
Construction and land development	\$ 139	\$ 886
1-4 family residential	470	643
Commercial real estate	536	655
	\$ 1,145	\$ 2,184

### Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$1,306,008,000 at September 30, 2016 compared to \$1,262,660,000 at December 31, 2015, an increase of \$43,348,000 or 3.43%. This growth is mostly in non-maturity, core deposits, the heart of our balance sheet.

The Company's primary focus on the liability side of the balance sheet is growing core deposits and their affiliated relationships. The continuing challenge in this ongoing low rate environment is to fund the Bank in a cost effective and competitive manner. The Company's cost of deposits for the third quarter of 2016 was 0.53%, up from 0.52% for the third quarter of 2015.

### Shareholders' Equity

The Company's capital management strategy is to be classified as "well capitalized" under regulatory capital ratios and provide as high as possible total return to shareholders.

Shareholders' equity was \$203,713,000 at September 30, 2016 compared to \$197,835,000 at December 31, 2015, an increase of \$5,878,000 or 2.97%.

The Company paid cash dividends of \$0.72 per share during the first nine months of 2016 while the aggregate basic and diluted earnings per share for the same period was \$1.41 per share.

In July 2013, the Board of Governors of the Federal Reserve System 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 capital conservation buffer requirement will be phased in beginning 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 provides information on the regulatory capital ratios for the Company and the Bank at September 30, 2016 and December 31, 2015. Management believes, as of September 30, 2016, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

	Percentage At September 30, 2016		Percentage At December 31, 2015	
Risk-Based Capital Ratios:	Company		Bank	
Common equity tier 1 capital ratio	12.45	14.02	12.88	14.58
Tier 1 capital ratio	14.66	14.02	15.23	14.58
Total capital ratio	15.72	15.06	16.34	15.67

#### Leverage Capital Ratio:

Tier 1 leverage ratio	11.83	11.32	12.05	11.54
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#### Stock Repurchase Plan

On November 19, 2015, 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 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 established at such number to equal to approximately 3.5% of the 8,622,000 shares then outstanding at the time the Board approved the program.

In the nine month period ended September 30, 2016, the Company repurchased 51,384 shares at an average cost of \$25.14 per share, for a total cost of \$1,292,000. During the same period in 2015, the Company repurchased 121,636 shares at an average cost of \$23.09 per share, for a total cost of \$2,808,000.

#### Liquidity

Liquidity is the ability of the Company to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities in a timely manner. 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 through policies approved by the Asset Liability Committee ("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, and increases in deposits.

The Company also 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 Bank'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, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. At September 30, 2016, principal advance obligations to the FHLB, net of acquisition related fair value adjustments, consisted of \$9,974,000 in fixed-rate, long-term advances compared to \$9,958,000 in fixed-rate, long-term advances at December 31, 2015. The Company also had outstanding \$70,700,000 in letters of credit at September 30, 2016 and at December 31, 2015. The letters of credit provide the Bank with alternate collateral for securing public entity deposits above Federal Deposit Insurance Company ("FDIC") insurance levels, thereby providing less need for

collateral pledging from the securities portfolio, and thereby maximizing on balance sheet liquidity.

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Short-term borrowings are discussed in Note 7 and long-term borrowings are discussed in Note 8 in the Consolidated Financial Statements included in this report.

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's discount window.

The Company 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 exceeding \$250,000. This gives the Company the ability, as and when needed, to attract and retain large deposits from insurance conscious customers. CDARS are classified as brokered deposits; however, they are generally derived from customers with whom the Company has or wishes to have a direct and ongoing relationship. As a result, management considers these deposits functionally, though not technically, 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 Bank can use CDARS to purchase cost-effective funding without collateralization and in lieu of generating funds through traditional brokered CDs or the FHLB. In this manner, CDARS can provide the Company with another funding option. Thus, CDARS serves as a deposit-gathering tool and an additional liquidity management tool. Deposits through the CDARS program as of September 30, 2016 and December 31, 2015, were \$25,634,000 and \$23,633,000, respectively.

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

#### 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 subsidiaries to issue trust preferred securities, the Company does not have any off-balance sheet subsidiaries. Off-balance sheet transactions at September 30, 2016 and at December 31, 2015 were as follows (dollars in thousands):

	September 30, December 31,	
	2016	2015
Commitments to extend credit	\$ 332,246	\$ 301,360
Standby letters of credit	4,063	4,286
Mortgage loan rate-lock commitments	13,924	5,365

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 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET 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 the 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

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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 September 30, 2016 is asset sensitive. 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 following table shows the estimated impact of changes in interest rates on net interest income as of September 30, 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	September 30, 2016	
	Change in Net Interest Income	
	Amount	Percent
Up 4.00%	\$6,724	13.2 %
Up 3.00%	5,167	10.1
Up 2.00%	3,510	6.9
Up 1.00%	1,790	3.5
Flat	—	—
Down 0.25%	(747 )	(1.5 )
Down 0.50%	(1,575 )	(3.1 )

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 quarterly period ended September 30, 2016 (dollars in thousands):  
Estimated Changes in Economic Value of Equity

Change in interest rates	September 30, 2016		
	Amount	\$ Change	% Change
Up 4.00%	\$234,064	\$56,198	31.6 %
Up 3.00%	229,550	51,684	29.1
Up 2.00%	220,722	42,856	24.1
Up 1.00%	203,938	26,072	14.7
Flat	177,866	—	—
Down 0.25%	168,629	(9,237 )	(5.2 )
Down 0.50%	158,767	(19,099 )	(10.7)

Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates. There have been no material changes to market risk as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Refer to those disclosures for further information.

#### ITEM 4. 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 Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of September 30, 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 September 30, 2016, that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

The nature of the business of the Company ordinarily results in a certain amount of litigation. The Company is involved in various legal proceedings, all of which are considered incidental to the normal conduct of business. Management believes that these proceedings will not have a material adverse effect on the consolidated financial position or consolidated results of operations of the Company.

## ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC on March 15, 2016.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On November 19, 2015, the Company's Board of Directors authorized a share repurchase program of up to 300,000 shares of the Company's outstanding common stock for a period of two years. Repurchases may be made through open market purchases or in privately negotiated transactions, and shares repurchased will be returned to the status of authorized and unissued shares of common stock. The actual timing, number, and value of shares repurchased under the program will be determined by management.

Shares of the Company's common stock were repurchased during the three months ended September 30, 2016, as detailed below. 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 September 30, 2016.

Period Beginning on First Day of Month Ended	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under Plans or Programs
July 31, 2016	—	\$—	—	238,323
August 31, 2016	3,408	26.17	3,408	234,915
September 30, 2016	—	—	—	234,915
Total	3,408	\$ 26.17	3,408	

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

## ITEM 5. OTHER INFORMATION

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

ITEM 6. EXHIBITS

- 11.0 Refer to EPS calculation in the Notes to Financial Statements
  - 31.1 Section 302 Certification of Jeffrey V. Haley, President and Chief Executive Officer
  - 31.2 Section 302 Certification of William W. Traynham, Executive Vice President and Chief Financial Officer
  - 32.1 Section 906 Certification of Jeffrey V. Haley, President and Chief Executive Officer
  - 32.2 Section 906 Certification of William W. Traynham, Executive Vice President and Chief Financial Officer
- Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) the Consolidated Statements of Income for the three and nine months ended September 30, 2016 and September 30, 2015, (iii) the Consolidated Statements of Comprehensive
- 101 Income for the three and nine months ended September 30, 2016 and September 30, 2015, (iv) the Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2016 and September 30, 2015, (v) the Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and September 30, 2015, and (vi) the Notes to the Consolidated Financial Statements (furnished herewith).

SIGNATURES

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

AMERICAN NATIONAL BANKSHARES INC.

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

Date - November 7, 2016 (principal executive officer)

/s/ William W. Traynham  
William W. Traynham  
Executive Vice President and  
Chief Financial Officer

Date - November 7, 2016 (principal financial officer)

/s/ Cathy W. Liles  
Cathy W. Liles  
Senior Vice President and  
Chief Accounting Officer

Date - November 7, 2016 (principal accounting officer)