ALWAYS
OUR
BEST.

Parkway Acquisition Corp.

2017 Annual Report

There's a united strength to this bank, just like this region. Yes, banking is a basic; but it's the supportive work and passion that we all put behind it that makes a difference—that caring connectedness and history we share. Our bank is able to flex, willing to assist, eager to help, able to customize and committed to partnership. We stand behind you, deliver our best service, provide solutions, stay close for the outcomes, and make those highly personal investments that are really outside of everything you'd expect from a bank.

Skyline National Bank

ALWAYS OUR BEST

2017 Annual Report

Table of Contents

Stockholder Information

Annual Meeting

The annual meeting of stockholders will be held at the Skyline National Bank Conference Center, 101 Jacksonville Circle, Floyd, Virginia, at 3:00 p.m. on Thursday, June 14, 2018.

Requests for Information

Requests for information should be directed to Mrs. Suzanne S. Yearout, Corporate Secretary, at Parkway Acquisition Corp, 101 Jacksonville Circle, P.O. Box 215, Floyd, Virginia 24091; telephone (540) 745-4191.

Independent Registered Public Accounting Firm

Elliott Davis, PLLC
500 East Morehead Street, Ste. 700
Charlotte, North Carolina, 28202

Stock Transfer Agent

Computershare
250 Royal Street
Canton, Massachusetts, 02021

Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

Banking Offices

Carroll} 8351 Carrollton Pike, Galax, VA 24333 P} 276/238-8112
Christiansburg} 2145 Roanoke Street, Christiansburg, VA 24073 P} 540/381-8121
East Independence} 802 East Main Street, Independence, VA 24348 P} 276/773-2821
Elk Creek} 60 Comers Rock Road, Elk Creek, VA 24326 P} 276/655-4011
Floyd} 101 Jacksonville Circle, Floyd, VA 24091 P} 540/745-4191
Galax} 209 West Grayson Street, Galax, VA 24333 P} 276/238-2411
Hillsville} 419 South Main Street, Hillsville, VA 24343 P} 276/728-2810
Independence Main Office & Operations Ctr} 113 West Main Street, Independence, VA 24348 P} 276/773-2811
Radford} 7349 Peppers Ferry Boulevard, Radford, VA 24141 P} 540/633-1680
Roanoke} 4094 Postal Drive, Roanoke, VA 24018 P} 540/774-1111
Salem} 1634 West Main Street, Salem, VA 24153 P} 540/387-4533
Sparta} 98 South Grayson Street, Sparta, NC 28675 P} 336/372-2811
Troutdale} 101 Ripshin Road, Troutdale, VA 24378 P} 276/677-3722
West Jefferson} 1055 Mount Jefferson Road, West Jefferson, NC 28694 P} 336-489-7811
Whitetop} 16303 Highlands Parkway, Whitetop, VA 24292 P} 276/388-3811
Willis} 5598 Floyd Highway South, Willis, VA 24380 P} 540/745-4191
Wytheville} 420 North 4th Street, Wytheville, VA 24382 P} 276/228-6050
Blacksburg Loan Production Office} 902 South Main Street, Blacksburg, VA 24060 P} 540/250-0280

Skyline Support Call Center} 1-866-773-2811

Financial Highlights[1]

	2017	2016	2015	2014	2013
Summary of Operations					
Interest income	$ 22,274	$ 17,562	$ 12,703	$ 12,996	$ 12,858
Interest expense	1,474	1,728	2,226	2,600	2,992
Net interest income	20,800	15,834	10,477	10,396	9,866
Provision for (reduction of) loan losses	217	(5)	(187)	294	1,233
Other income	4,228	4,570	2,511	2,961	2,598
Other expense	19,280	16,816	11,580	11,902	11,455
Income taxes (benefit)	3,104	1,175	598	295	(229)
Net income	$ 2,427	$ 2,418	$ 997	$ 866	$ 5
Per Share Data					
Net income	$ .48	$ .60	$ .58	$ .50	$ -
Cash dividends declared	.16	.12	.10	-	-
Book value	11.39	11.05	17.83	17.43	16.39
Year-end Balance Sheet Summary					
Loans, net	$ 421,418	$ 408,548	$ 237,798	$ 218,805	$ 207,107
Investment securities	50,675	62,540	56,050	69,037	70,404
Total assets	547,961	558,856	331,760	333,064	331,461
Deposits	488,441	499.387	279,876	282,136	282,376
Stockholders' equity	57,182	55,466	30,656	29,698	28,167
Selected Ratios					
Return on average assets	0.44%	0.55%	0.30%	0.26%	0.00%
Return on average equity	4.28%	5.62%	3.22%	2.93%	0.02%
Average equity to average assets	10.32%	9.78%	9.33%	8.94%	8.71%

1 In thousands of dollars, except per share data.

Parkway Acquisition Corp.

Dear Fellow Stockholders:

It is our pleasure to present the year end 2017 Financial Report for Parkway Acquisition Corp. and Skyline National Bank. 2017 marked the first full year of combined operations since the merger in which Grayson Bankshares, Inc. and Cardinal Bankshares Corp, joined forces to become Parkway Acquisition Corp in July of 2016, and we believe the year was a success. We combined our companies based on the belief that it would enhance shareholder value through increased earnings potential, increased stock value and increased stock liquidity, among other things, and 2017 saw each of these beliefs come to pass.

Earnings for the year totaled $2.4 million, despite the negative impact of a $1.4 million, nonrecurring charge to income tax expense that came as a result of the Tax Cuts and Jobs Act which was signed into law on December 22, 2017. Earnings, without the one-time adjustment, totaled $3.8 million, which was consistent with our expectations and demonstrates the solid core earnings potential for our company going forward. Financially, we ended the year with total assets of $548 million, net loans of $421 million, and total deposits of $488 million. Our equity at year end was $57 million, representing a tangible book value of $10.98 per share.

We were excited to announce on March 1, 2018, that we entered into an Agreement and Plan of Merger with Great State Bank whereby Parkway will acquire Great State Bank. The agreement provides that, subject to certain terms and conditions, Great State Bank will merge with and into Skyline, with Skyline as the surviving bank in the Merger. Great State Bank is a Wilkesboro, North Carolina-based bank with branches in Boone, Wilkesboro and Yadkinville, North Carolina and loan production offices in Lenoir and Shelby, North Carolina. As of December 31, 2017, Great State Bank had total assets of $139 million. The proposed merger is expected to be completed in the third quarter of 2018, subject to approval of both companies' shareholders, regulatory approvals, and other customary closing conditions. We are excited about this combination because it will expand our presence into several North Carolina counties adjacent to our branch in Sparta and our planned branch opening in West Jefferson, which is scheduled for mid-April. You can find additional information about the proposed merger by visiting our website at www.skylinenationalbank.com. Check the website as well for an upcoming announcement regarding the grand opening date for the West Jefferson branch. We hope that many of you will be able to attend and help us celebrate the occasion.

In mid-March, you should have received your semi-annual dividend of 10 cents per share, an increase of 2 cents from the September 2017 dividend amount. Your Board of Directors will address dividends again in the Fall of 2018. **If you have not already done so, we encourage you to be in touch with our transfer agent, Computershare, to complete the transfer of your Grayson and Cardinal shares into shares of Parkway.**

We look forward to seeing you at our 2018 Annual Shareholders' Meeting. Notice of the meeting, including the date, time, and location, will be provided by mail and posted on our website as soon as it becomes available. We always appreciate the opportunity to visit with our shareholders, listen to your comments, and answer any questions you may have.

Always Our Best,

Allan Funk
President and CEO

elliott davis

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Parkway Acquisition Corp.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Parkway Acquisition Corp. and its subsidiary (the "Company") as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

Elliott Davis, PLLC

We have served as the Company's auditor since 1995.

Charlotte, North Carolina
March 23, 2018

Consolidated Balance Sheets

December 31, 2017 and 2016

(dollars in thousands)	2017	2016
Assets		
Cash and due from banks	$ 6,367	$ 7,215
Interest-bearing deposits with banks	8,739	19,399
Federal funds sold	7,769	9,294
Investment securities available for sale	50,675	62,540
Restricted equity securities	1,388	1,149
Loans, net of allowance for loan losses of $3,453 at December 31, 2017 and $3,420 at December 31, 2016	421,418	408,548
Cash value of life insurance	17,348	16,850
Foreclosed assets	-	70
Properties and equipment, net	17,646	17,970
Accrued interest receivable	1,737	1,732
Core deposit intangible	2,045	2,327
Deferred tax assets, net	2,965	5,872
Other assets	9,864	5,890
	$ 547,961	$ 558,856
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	$ 130,847	$ 127,224
Interest-bearing	357,594	372,163
Total deposits	488,441	499,387
Accrued interest payable	46	57
Other liabilities	2,292	3,946
	490,779	503,390
Commitments and contingencies (Note 16)		
Stockholders' Equity		
Preferred stock, no par value; 5,000,000 shares authorized, none issued	-	-
Common stock, no par value; 25,000,000 shares authorized, 5,021,376 issued and outstanding at December 31, 2017 and 2016, respectively	-	-
Surplus	26,166	26,166
Retained earnings	32,526	30,654
Accumulated other comprehensive income (loss)	(1,510)	(1,354)
	57,182	55,466
	$ 547,961	$ 558,856

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Years ended December 31, 2017 and 2016

(dollars in thousands except share amounts)	2017	2016
Interest income		
Loans and fees on loans	$ 20,722	$ 16,284
Interest-bearing deposits in banks	48	37
Federal funds sold	111	46
Interest on securities:		
Taxable	1,302	1,129
Exempt from federal income tax	-	3
Dividends	91	63
	22,274	17,562
Interest expense		
Deposits	1,473	1,286
Interest on borrowings	1	442
	1,474	1,728
Net interest income	20,800	15,834
Provision for loan losses	217	(5)
Net interest income after provision for loan losses	20,583	15,839
Noninterest income		
Service charges on deposit accounts	1,326	1,256
Other service charges and fees	1,597	1,346
Net realized gains on securities	242	364
Mortgage origination fees	293	167
Increase in cash value of life insurance	444	382
Bargain purchase gain	-	891
Other income	326	164
	4,228	4,570
Noninterest expenses		
Salaries and employee benefits	10,283	8,630
Occupancy and equipment	2,588	1,985
Foreclosed asset expense, net	44	79
Data processing expense	1,177	888
FDIC Assessments	272	247
Advertising	612	211
Bank franchise tax	397	270
Professional fees	430	327
Supplies	277	159
Director fees	327	257
Merger related expenses	748	1,483
Other expense	2,125	2,280
	19,280	16,816
Income before income taxes	5,531	3,593
Income tax expense related to ordinary operations	1,669	1,175
Income tax expense related to change in tax rate	1,435	-
Total income tax expense	3,104	1,175
Net income	$ 2,427	$ 2,418
Basic earnings per share	$ 0.48	$ 0.60
Weighted average shares outstanding	5,021,376	4,026,114
Dividends declared per share	$ 0.16	$ 0.12

See Notes to Consolidated Financial Statements

Consolidated Statements of Comprehensive Income

Years ended December 31, 2017 and 2016

(dollars in thousands)	**2017**	**2016**
Net Income	$ 2,427	$ 2,418
Other comprehensive income (loss)		
Net change in pension reserve:		
Change in pension reserve during the year	(67)	(261)
Tax related to change in pension reserve	23	89
Unrealized gains (losses) on investment securities available for sale:		
Unrealized gains (losses) arising during the year	449	(331)
Tax related to unrealized (gains) losses	(153)	113
Reclassification of net realized gains during the year	(242)	(364)
Tax related to realized gains	82	124
Total other comprehensive income (loss)	92	(630)
Total comprehensive income	$ 2,519	$ 1,788

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2017 and 2016

(dollars in thousands except share amounts)

	Common Stock				Accumulated Other Comprehensive	
	Shares	Amount	Surplus	Retained Earnings	Loss	Total
Balance, December 31, 2015	1,718,968	$ 2,149	$ 522	$ 28,709	$ (724)	$ 30,656
Net income	-	-	-	2,418	-	2,418
Other comprehensive loss	-	-	-	-	(630)	(630)
Conversion of common stock in connection with new holding company on July 1, 2016:						
Exchange of Grayson common stock, $1.25 par value	(1,718,968)	(2,149)	-	-	-	(2,149)
For Parkway common stock, no par value	3,025,384	-	2,419	-	-	2,149
Issuance of common stock in connection with acquisition of Cardinal Bankshares Corp	1,996,453	-	23,500	-	-	23,500
Redemption of fractional shares Issued in acquisition of Cardinal Bankshares Corp	(461)	-	(5)	-	-	(5)
Dividends paid prior to conversion	-	-	-	(172)	-	(172)
Dividends paid ($0.06 per share)	-	-	-	(301)	-	(301)
Balance, December 31, 2016	5,021,376	$ -	$ 26,166	$ 30,654	$ (1,354)	$ 55,466
Net income	-	-	-	2,427	-	2,427
Other comprehensive income	-	-	-	-	92	92
Reclassification of accumulated other comprehensive loss due to tax rate change	-	-	-	248	(248)	-
Dividends paid ($0.16 per share)	-	-	-	(803)	-	(803)
Balance, December 31, 2017	5,021,376	$ -	$ 26,166	$ 32,526	$ (1,510)	$ 57,182

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Years ended December 31, 2017 and 2016

(dollars in thousands)	2017	2016
Cash flows from operating activities		
Net income	$ 2,427	$ 2,418
Adjustments to reconcile net income		
to net cash provided by operations:		
Depreciation and amortization	1,315	883
Amortization of core deposit intangible	282	142
Accretion of loan discount and deposit premium, net	(1,245)	(1,047)
Bargain purchase gain	-	(891)
Increase in (reduction of) loan loss provision	217	(5)
Deferred income taxes	2,891	1,154
Net realized gains on securities	(242)	(364)
Accretion of discount on securities, net of		
amortization of premiums	671	602
Deferred compensation	(50)	(77)
Net realized loss on foreclosed assets	23	37
Life insurance income	-	(97)
Changes in assets and liabilities:		
Cash value of life insurance	(444)	(382)
Accrued interest receivable	(5)	100
Other assets	(4,127)	(209)
Accrued interest payable	(11)	(147)
Other liabilities	(1,604)	1,462
Net cash provided by operating activities	98	3,579
Cash flows from investing activities		
Activity in available for sale securities:		
Purchases	(1,914)	(17,881)
Sales	8,664	55,115
Maturities/calls/paydowns	4,893	14,349
Sales (purchases) or restricted equity securities	(239)	1,131
Net increase in loans	(12,070)	(12,105)
Proceeds from life insurance contracts	-	321
Proceeds from the sale of foreclosed assets	47	326
Purchases of property and equipment, net of sales	(991)	(674)
Cash received in business combination	-	11,698
Net cash (used in) provided by investing activities	(1,610)	52,280
Cash flows from financing activities		
Net (decrease) increase in deposits	(10,718)	472
Net decrease in borrowings	-	(28,000)
Cash paid for fractional shares	-	(5)
Dividends paid	(803)	(473)
Net cash used in financing activities	(11,521)	(28,006)
Net (decrease) increase in cash and cash equivalents	(13,033)	27,853
Cash and cash equivalents, beginning	35,908	8,055
Cash and cash equivalents, ending	$ 22,875	$ 35,908

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Years ended December 31, 2017 and 2016

(dollars in thousands)	**2017**	**2016**
Supplemental disclosure of cash flow information		
Interest paid	$ 1,485	$ 1,840
Taxes paid	$ 70	$ 320
Supplemental disclosure of noncash investing activities		
Effect on equity of change in net unrealized loss on available for sale securities	$ 136	$ (458)
Effect on equity of change in unfunded pension liability	$ (44)	$ (172)
Transfers of loans to foreclosed properties	$ -	$ 25
Business combinations		
Assets acquired	$ -	$ 253,135
Liabilities assumed	-	228,744
Net assets	$ -	$ 24,391
Bargain purchase gain	$ -	$ 891
Stock issued to acquire Cardinal Bankshares Corp.	$ -	$ 23,500

See Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

Organization

Parkway Acquisition Corp. ("Parkway") was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell for the purpose of completing a business combination transaction between Grayson Bankshares, Inc. ("Grayson") and Cardinal Bankshares Corporation ("Cardinal"). On November 6, 2015, Grayson, Cardinal and Parkway entered into an Agreement and Plan of Merger (the "merger agreement"), providing for the combination of the three companies. Terms of the merger agreement called for Grayson and Cardinal to merge with and into Parkway, with Parkway as the surviving corporation (the "merger"). The merger agreement established exchange ratios under which each share of Grayson common stock was converted to the right to receive 1.76 shares of common stock of Parkway, while each share of Cardinal common stock was converted to the right to receive 1.30 shares of common stock of Parkway. The exchange ratios resulted in Grayson shareholders receiving approximately 60% of the newly issued Parkway shares and Cardinal shareholders receiving approximately 40% of the newly issued Parkway shares. The merger was completed on July 1, 2016. Grayson is considered the acquiror and Cardinal is considered the acquiree in the transaction for accounting purposes.

Upon completion of the merger, the Bank of Floyd, a wholly-owned subsidiary of Cardinal, was merged with and into Grayson National Bank (the "Bank'), a wholly-owned subsidiary of Grayson. The Bank was organized under the laws of the United States in 1900 and now serves the Virginia counties of Grayson, Floyd, Carroll, Wythe, Montgomery and Roanoke, and the surrounding areas through sixteen full-service banking offices and two loan production offices. Effective March 13, 2017, the Bank changed its name to Skyline National Bank ("Skyline"). As an FDIC-insured National Banking Association, the Bank is subject to regulation by the Comptroller of the Currency. Parkway is regulated by the Board of Governors of the Federal Reserve System.

For purposes of this annual report on Form 10-K, all information contained herein as of and for periods prior to July 1, 2016 reflects the operations of Grayson prior to the merger. Unless this report otherwise indicates or the context otherwise requires, all references to "Parkway" or the "Company" as of and for periods subsequent to July 1, 2016 refer to the combined company and its subsidiary as a combined entity after the merger, and all references to the "Company" as of and for periods prior to July 1, 2016 are references to Grayson and its subsidiary as a combined entity prior to the merger.

Critical Accounting Policies

Management believes the policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and the Board of Directors.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and the Bank, which is wholly owned. All significant, intercompany transactions and balances have been eliminated in consolidation.

Business Segments

The Company reports its activities as a single business segment. In determining the appropriateness of segment definition, the Company considers components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Business Combinations

Generally, acquisitions are accounted for under the acquisition method of accounting in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 805, Business Combinations. A business combination occurs when the Company acquires net assets that constitute a business, or acquires equity interests in one or more other entities that are businesses and obtains control over those entities. Business combinations are effected through the transfer of consideration consisting of cash and/or common stock and are accounted for using the acquisition method. Accordingly, the assets and liabilities of the acquired entity are recorded at their respective fair values as of the closing date of the acquisition. Determining the fair value of assets and liabilities, especially the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values becomes available. The results of operations of an acquired entity are included in our consolidated results from the closing date of the merger, and prior periods are not restated. No allowance for loan losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding future credit losses. The fair value estimates associated with the acquired loans include estimates related to expected prepayments and the amount and timing of expected principal, interest and other cash flows.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for loan and foreclosed real estate losses, management obtains independent appraisals for significant properties.

Substantially all of the Bank's loan portfolio consists of loans in its market area. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of a substantial portion of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions. The regional economy is diverse, but influenced to an extent by the manufacturing and agricultural segments.

While management uses available information to recognize loan and foreclosed real estate losses, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as a part of their routine examination process, periodically review the Bank's allowances for loan and foreclosed real estate losses. Such agencies may require the Bank to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for loan and foreclosed real estate losses may change materially in the near term.

The Company seeks strategies that minimize the tax effect of implementing their business strategies. As such, judgments are made regarding the ultimate consequence of long-term tax planning strategies, including the likelihood of future recognition of deferred tax benefits. The Company's tax returns are subject to examination by both Federal and State authorities. Such examinations may result in the assessment of additional taxes, interest and penalties. As a result, the ultimate outcome, and the corresponding financial statement impact, can be difficult to predict with accuracy.

Accounting for pension benefits, costs and related liabilities are developed using actuarial valuations. These valuations include key assumptions determined by management, including the discount rate and expected long-term rate of return on plan assets. Material changes in pension costs may occur in the future due to changes in these assumptions.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents includes cash and amounts due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold.

Trading Securities

The Company does not hold securities for short-term resale and therefore does not maintain a trading securities portfolio.

Securities Held to Maturity

Bonds, notes, and debentures for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity. The Company does not currently hold any securities classified as held to maturity.

Securities Available for Sale

Available for sale securities are reported at fair value and consist of bonds, notes, debentures, and certain equity securities not classified as trading securities or as held to maturity securities.

Unrealized holding gains and losses, net of tax, on available for sale securities are reported as a net amount in a separate component of accumulated other comprehensive income. Realized gains and losses on the sale of available for sale securities are determined using the specific-identification method. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Declines in the fair value of individual held to maturity and available for sale securities below cost that are other than temporary are reflected as write-downs of the individual securities to fair value. Related write-downs are included in earnings as realized losses.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal amount adjusted for any charge-offs and the allowance for loan losses. Loan origination costs are capitalized and recognized as an adjustment to yield over the life of the related loan.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Payments received are first applied to principal, and any remaining funds are then applied to interest. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

Purchased Performing Loans – The Company accounts for performing loans acquired in business combinations using the contractual cash flows method of recognizing discount accretion based on the acquired loans' contractual cash flows. Purchased performing loans are recorded at fair value, including a credit discount. The fair value discount is accreted as an adjustment to yield over the estimated lives of the loans. There is no allowance for loan losses established at the acquisition date for purchased performing loans. A provision for loan losses is recorded for any further deterioration in these loans subsequent to the acquisition

Note 1. Organization and Summary of Significant Accounting Policies, continued

Loans Receivable, continued

Purchased Credit-Impaired ("PCI") Loans – Loans purchased with evidence of credit deterioration since origination, and for which it is probable that all contractually required payments will not be collected, are considered credit impaired. Evidence of credit quality deterioration as of the purchase date may include statistics such as internal risk grade and past due and nonaccrual status. Purchased impaired loans generally meet the Company's definition for nonaccrual status. PCI loans are initially measured at fair value, which reflects estimated future credit losses expected to be incurred over the life of the loan. Accordingly, the associated allowance for credit losses related to these loans is not carried over at the acquisition date. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference, and is available to absorb credit losses on those loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges, or a reclassification of the nonaccretable difference with a positive impact on future interest income.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance, or portion thereof, is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component is calculated on an individual basis for larger-balance, non-homogeneous loans, which are considered impaired. A specific allowance is established when the discounted cash flows, collateral value (less disposal costs), or observable market price of the impaired loan is lower than its carrying value. The specific component of the allowance for smaller-balance loans whose terms have been modified in a troubled debt restructuring (TDR) is calculated on a pooled basis considering historical experience adjusted for qualitative factors. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for all loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Troubled Debt Restructurings

Under GAAP, the Bank is required to account for certain loan modifications or restructurings as “troubled debt restructurings” or "troubled debt restructured loans." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower’s financial difficulties grants a concession to the borrower that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower do not necessarily always constitute a troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. Troubled debt restructured loans are maintained in nonaccrual status until they have been performing in accordance with modified terms for a period of at least six months.

Property and Equipment

Land is carried at cost. Bank premises, furniture and equipment are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives:

	Years
Buildings and improvements	10-40
Furniture and equipment	5-12

Foreclosed Assets

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less anticipated cost to sell at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in foreclosure expense on the consolidated statements of income.

Pension Plan

Prior to the merger, both Grayson National Bank (Grayson) and Bank of Floyd (Floyd) had qualified noncontributory defined benefit pension plans in place which covered substantially all of each bank’s employees. The benefits in each plan are primarily based on years of service and earnings. Both Grayson and Floyd plans were amended to freeze benefit accruals for all eligible employees prior to the effective date of the merger. Grayson’s plan is a single-employer plan, the funded status of which is measured as the difference between the fair value of plan assets and the projected benefit obligation. Floyd’s plan is a multi-employer plan for accounting purposes and is a multiple-employer plan under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code.

Transfers of Financial Assets

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

Core Deposit Intangible

Core deposit intangibles represent the value of long-term deposit relationships acquired in a business combination. Core deposit intangibles are amortized over the estimated useful lives of the deposit accounts acquired (generally twenty years on an accelerated basis).

Note 1. Organization and Summary of Significant Accounting Policies, continued

Income Taxes

Provision for income taxes is based on amounts reported in the statements of income (after exclusion of non-taxable income such as interest on state and municipal securities) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more likely than not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more likely than not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company has early adopted ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" which is considered a change in accounting principle. Because the required adjustment of deferred taxes is required to be included in income from continuing operations, the tax effects of items within accumulated other comprehensive income (commonly referred to as "stranded" tax effects) would not reflect the appropriate tax rate. Adoption of this ASU eliminates the "stranded" tax effects associated with the change in the federal corporate income tax rate in the Tax Cuts and Jobs Act of 2017. The Company has reclassified "stranded" tax effects totaling $248 thousand from accumulated other comprehensive loss to retained earnings and these reclassified amounts are reflected in the accompanying consolidated statements of changes in stockholders' equity.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and changes in the funded status of the pension plan which are also recognized as separate components of equity. The accumulated balances related to each component of other comprehensive income (loss) are as follows:

(dollars in thousands)	Unrealized Gains And Losses On Available for Sale Securities	Defined Benefit Pension Items	Total
Balance, December 31, 2015	**$ (116)**	**$ (608)**	**$ (724)**
Other comprehensive loss before reclassifications	(218)	(172)	(390)
Amounts reclassified from accumulated other comprehensive (loss)	(240)	-	(240)
Balance, December 31, 2016	**$ (574)**	**$ (780)**	**$ (1,354)**
Other comprehensive income (loss) before reclassifications	296	(44)	252
Amounts reclassified from accumulated other comprehensive loss	(160)	-	(160)
Amounts reclassified to retained earnings from other comprehensive loss due to tax rate change	(85)	(163)	(248)
Balance, December 31, 2017	**$ (523)**	**$ (987)**	**$ (1,510)**

Note 1. Organization and Summary of Significant Accounting Policies, continued

Advertising Expense

The Company expenses advertising costs as they are incurred. Advertising expense for the years presented is not material.

Basic Earnings per Share

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period, after giving retroactive effect to stock splits and dividends.

Off-Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under line of credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 12. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Reclassification

Certain reclassifications have been made to the prior years' financial statements to place them on a comparable basis with the current presentation. Net income and stockholders' equity previously reported were not affected by these reclassifications.

Recent Accounting Pronouncements

The following accounting standards may affect the future financial reporting by the Company:

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company's revenue is comprised of net interest income and noninterest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of our revenues will not be affected. The Company is currently assessing our revenue contracts related to revenue streams that are within the scope of the standard. Our accounting policies will not change materially since the principles of revenue recognition from the ASU are largely consistent with existing guidance and current practices applied by our businesses. We have not identified material changes to the timing or amount of revenue recognition. Based on the updated guidance, we do anticipate changes in our disclosures associated with our revenues. We will provide qualitative disclosures of our performance obligations related to our revenue recognition and we continue to evaluate disaggregation for significant categories of revenue in the scope of the guidance.

In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reposting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

In January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

We expect to adopt the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. We have started an initial evaluation of our leasing contracts and activities. We have also started developing our methodology to estimate the right-of use assets and lease liabilities, which is based on the present value of lease payments. We do not expect a material change to the timing of expense recognition, but we are early in the implementation process and will continue to evaluate the impact. We are evaluating our existing disclosures and may need to provide additional information as a result of adoption of the ASU.

In March 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify the implementation guidance on principal versus agent considerations and address how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2019. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. While early adoption is permitted beginning in first quarter 2019, we do not expect to elect that option. We are evaluating the impact of the ASU on our consolidated financial statements. We expect the ASU will result in an increase in the recorded allowance for loan losses given the change to estimated losses over the contractual life of the loans adjusted for expected prepayments. The majority of the increase results from longer duration portfolios. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

In December 2016, the FASB issued technical corrections and improvements to the Revenue from Contracts with Customers Topic. These corrections make a limited number of revisions to several pieces of the revenue recognition standard issued in 2014. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2017, the FASB issued guidance to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendment to the Business Combinations Topic is intended to address concerns that the existing definition of a business has been applied too broadly and has resulted in many transactions being recorded as business acquisitions that in substance are more akin to asset acquisitions. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2017, the FASB updated the Accounting Changes and Error Corrections and the Investments—Equity Method and Joint Ventures Topics of the Accounting Standards Codification. The ASU incorporates into the Accounting Standards Codification recent SEC guidance about disclosing, under SEC SAB Topic 11.M, the effect on financial statements of adopting the revenue, leases, and credit losses standards. The ASU was effective upon issuance. The Company is currently evaluating the impact on additional disclosure requirements as each of the standards is adopted, however it does not expect these amendments to have a material effect on its financial position, results of operations or cash flows.

In February 2017, the FASB amended the Other Income Topic of the Accounting Standards Codification to clarify the scope of the guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets. The amendments conform the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2017, the FASB amended the requirements in the Compensation—Retirement Benefits Topic of the Accounting Standards Codification related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2017, the FASB amended the requirements in the Receivables—Nonrefundable Fees and Other Costs Topic of the Accounting Standards Codification related to the amortization period for certain purchased callable debt securities held at a premium. The amendments shorten the amortization period for the premium to the earliest call date. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2017, the FASB updated the Income Statement and Revenue from Contracts with Customers Topics of the Accounting Standards Codification. The amendments incorporate into the Accounting Standards Codification recent SEC guidance related to revenue recognition. The amendments were effective upon issuance. The Company is currently evaluating the impact on revenue recognition, however it does not expect these amendments to have a material effect on its financial statements.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

In February 2018, the FASB Issued ASU 2018-02, Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which requires Companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act. The Company has opted to early adopt this pronouncement by retrospective application to each period in which the effect of the change in the tax rate under the Tax Cuts and Jobs Act is recognized. The impact of the reclassification from other comprehensive income to retained earnings is $248 thousand for the year ended December 31, 2017.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's consolidated financial position, results of operations or cash flows.

Note 2. Business Combinations

On July 1, 2016, Parkway completed its merger with Grayson and Cardinal. Parkway had no material assets or liabilities and did not conduct any business prior to consummation of the merger except to perform its obligations under the merger agreement. As such, Grayson was considered the acquiring entity in this business combination for accounting purposes. Under the terms of the merger agreement, each share of Grayson common stock was converted to the right to receive 1.76 shares of common stock of Parkway, while each share of Cardinal common stock was converted to the right to receive 1.30 shares of common stock of Parkway. There was no trading market and no market price for Parkway common stock on the date of the transaction. Parkway was quoted on the OTC Markets and began trading on August 31, 2016; however, Parkway was a new company and the stock was thinly traded. Grayson, as the accounting acquirer at the time of the merger, was also thinly traded and the limited number of shares traded prior to the acquisition were not considered indicative of trading value. Due to the limited trading history of Parkway and Grayson, the Company engaged a third party to determine the value of the transaction as well as the value of the consideration paid to Cardinal as a result of the transaction. The Company also engaged a third party to calculate fair values of all assets and liabilities acquired in the transaction. These valuations were subject to review and refinement for up to one year following the merger date, however so subsequent valuation adjustments were made.

Note 2. Business Combinations, continued

The following table presents the Cardinal assets acquired and liabilities assumed as of July 1, 2016 as well as the related fair value adjustments and determination of purchase gain.

(dollars in thousands)	As Reported by Cardinal	Fair Value Adjustments		As Reported by Parkway
Assets				
Cash and cash equivalents	$ 11,698	$ -		$ 11,698
Investment securities	59,327	(322)	(a)	59,005
Restricted equity securities	1,308	-		1,308
Loans	164,044	(6,192)	(b)	157,852
Allowance for loan losses	(2,123)	2,123	(c)	-
Cash value of life insurance	6,714	-		6,714
Property and equipment	5,384	1,039	(d)	6,423
Intangible assets	-	2,469	(e)	2,469
Accrued interest receivable	539	-		539
Other assets	2,450	4,677	(f)	7,127
Total assets acquired	$ 249,341	$ 3,794		$ 253,135
Liabilities				
Deposits	$ 218,671	$ 602	(g)	$ 219,273
Borrowings	8,000	-	(h)	8,000
Accrued interest payable	35	-		35
Other liabilities	1,289	147	(i)	1,436
Total liabilities acquired	$ 227,995	$ 749		$ 228,744
Net assets acquired				24,391
Total consideration paid				23,500
Purchase gain				$ 891

Explanation of fair value adjustments:

(a) Reflects the opening fair value of securities portfolio, which was established as the new book basis of the portfolio.

(b) Reflects the fair value adjustment based on the Company's third party valuation report.

(c) Existing allowance for loan losses eliminated to reflect accounting guidance.

(d) Estimated adjustment to Cardinal's real property based upon third-party appraisals and the Company's evaluation of equipment and other fixed assets.

(e) Reflects the recording of the estimated core deposit intangible based on the Company's third party valuation report.

(f) Recording of deferred tax asset generated by the net fair value adjustments (tax rate = 34%). Also recognizes partial reversal of Cardinal's deferred tax asset valuation allowance.

(g) Estimated fair value adjustment to time deposits based on the Company's third party evaluation report on deposits assumed.

(h) Cardinal's borrowings were overnight borrowings and carried at fair value therefore no adjustment was required.

(i) Reflects the fair value adjustment based on the Company's evaluation of acquired other liabilities.

The merger was accounted for under the acquisition method of accounting. The assets and liabilities of Cardinal were recorded at their estimated fair values and added to those of Grayson for periods following the merger date. Valuations of acquired Cardinal assets and liabilities were subject to refinement for up to one year following the merger date.

Note 2. Business Combinations, continued

There are two methods to account for acquired loans as part of a business combination. Acquired loans that contain evidence of credit deterioration on the date of purchase are carried at the net present value of expected future proceeds in accordance with Financial Accounting Standards Board Accounting Standards Codification ("ASC") 310-30. All other acquired loans are recorded at their initial fair value, adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and any other adjustment to carrying value in accordance with ASC 310-20.

Due to the limited trading history of Parkway and Grayson, the Company engaged a third party to determine the value of the transaction as well as the value of the consideration paid to Cardinal as a result of the transaction. The determined value of consideration received by Cardinal, when compared to the fair value of the net assets acquired from Cardinal, resulted in a bargain purchase gain of $891 thousand. The determined value of consideration received by Cardinal represented a premium when compared to the market price of Parkway stock, which was not publicly traded on the date of the merger. The premium results from enhanced cash flows and a lower required rate of return which are expected to be realized by Parkway, as compared to Grayson or Cardinal on a standalone basis. The merger of Grayson and Cardinal is expected to increase loan revenues due to an increased legal lending limit and expanded market area. Fee income is also expected to increase due to the larger deposit population. Significant cost savings are expected to be realized, particularly in the areas of salaries and benefits, data processing fees, and professional fees. A lower required rate of return is anticipated due to increased access to capital and an expected increase in liquidity of shares due to higher trading volumes.

The following table presents the assets and liabilities of Parkway and Grayson prior to the merger, the estimated fair value of Cardinal assets acquired and liabilities assumed, and the resulting estimated balance sheet of Parkway immediately following the merger on July 1, 2016.

(dollars in thousands)	Pre-Merger Parkway	Pre-Merger Grayson	Cardinal Acquired	Post-Merger Parkway
Assets				
Cash and cash equivalents	$ -	$ 13,117	$ 11,698	$ 24,815
Investment securities	-	33,847	59,005	92,852
Restricted equity securities	-	971	1,308	2,279
Loans	-	244,800	157,852	402,652
Allowance for loan losses	-	(3,309)	-	(3,309)
Cash value of life insurance	-	10,122	6,714	16,836
Foreclosed assets	-	95	-	95
Property and equipment	-	11,548	6,423	17,971
Goodwill and other intangible assets	-	-	2,469	2,469
Accrued interest receivable	-	1,253	539	1,792
Other assets	-	5,044	7,127	12,171
Total assets	$ -	$ 317,488	$ 253,135	$ 570,623
Liabilities				
Deposits	$ -	$ 274,265	$ 219,273	$ 493,538
Borrowings	-	10,000	8,000	18,000
Accrued interest payable	-	96	35	131
Other liabilities	-	1,146	1,436	2,582
Total liabilities	$ -	$ 285,507	$ 228,744	$ 514,251
Shareholders' Equity	$ -	$ 31,981	$ 24,391	$ 56,372

Note 2. Business Combinations, continued

Supplemental Pro Forma Information (dollars in thousands except per share data)

The table below presents supplemental pro forma information as if the Cardinal acquisition had occurred at the beginning of the earliest period presented, which was January 1, 2016. Pro forma results include adjustments for amortization and accretion of fair value adjustments and do not include any projected cost savings or other anticipated benefits of the merger. Therefore, the pro forma financial information is not indicative of the results of operations that would have occurred had the transactions been effected on the assumed date. Pre-tax merger-related costs of $1.5 million are included in the Company's consolidated statements of operations for the year ended December 31, 2016, and are not included in the pro forma information below.

	Year Ended December 31, 2016 (unaudited)
Net interest income	$ 19,620
Net income (a)	$ 2,935
Basic and diluted weighted average shares outstanding (b)	5,021,376
Basic and diluted earnings per common share	$ 0.58

(a) Supplemental pro forma net income includes the impact of certain fair value adjustments. Supplemental pro forma net income does not include assumptions on cost savings or the impact of merger-related expenses.

(b) Weighted average shares outstanding includes the full effect of the common stock issued in connection with the Cardinal acquisition as of the earliest reporting date.

From the acquisition date of July 1, 2016 through December 31, 2016, Cardinal recorded actual net interest income of $3.5 million, non-interest income of $415 thousand, and net income of $133 thousand. These results do not include adjustments for amortization and accretion of fair value adjustments resulting from the application of purchase accounting guidance.

Note 3. Restrictions on Cash

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately $3.6 million and $4.6 million for the periods including December 31, 2017 and 2016, respectively.

Note 4. Investment Securities

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. The amortized cost of securities and their approximate fair values at December 31 follow:

(dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
2017				
Available for sale:				
Mortgage-backed securities	$ 28,780	$ -	$ (626)	$ 28,154
Corporate securities	3,016	-	(80)	2,936
State and municipal securities	19,542	155	(112)	19,585
	$ 51,338	$ 155	$ (818)	$ 50,675
2016				
Available for sale:				
Government sponsored enterprises	$ 2,046	$ 236	$ (73)	$ 2,209
Mortgage-backed securities	36,021	4	(823)	35,202
Corporate securities	3,061	-	(87)	2,974
State and municipal securities	22,282	97	(224)	22,155
	$ 63,410	$ 337	$ (1,207)	$ 62,540

Restricted equity securities were $1.4 million and $1.1 million at December 31, 2017 and 2016, respectively. Restricted equity securities consist of investments in stock of the Federal Home Loan Bank of Atlanta (FHLB), Community Bankers Bank, Pacific Coast Bankers Bank, and the Federal Reserve Bank of Richmond, all of which are carried at cost. All of these entities are upstream correspondents of the Bank. The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow money. The Bank is required to hold that stock so long as it borrows from the FHLB. The Federal Reserve requires Banks to purchase stock as a condition for membership in the Federal Reserve System. The Bank's stock in Community Bankers Bank and Pacific Coast Bankers Bank is restricted only in the fact that the stock may only be repurchased by the respective banks.

The following tables details unrealized losses and related fair values in the Company's held to maturity and available for sale investment securities portfolios. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2017 and 2016.

	Less Than 12 Months		12 Months or More		Total	
(dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2017						
Available for sale:						
Mortgage-backed securities	$ 15,791	$ (324)	$ 12,361	$ (302)	$ 28,152	$ (626)
Corporate securities	1,506	(10)	1,430	(70)	2,936	(80)
State and municipal securities	5,284	(44)	2,758	(68)	8,042	(112)
Total securities available for sale	$ 22,581	$ (378)	$ 16,549	$ (440)	$ 39,130	$ (818)
2016						
Available for sale:						
Government sponsored enterprises	$ -	$ -	$ 1,924	$ (73)	$ 1,924	$ (73)
Mortgage-backed securities	31,759	(789)	688	(34)	32,447	(823)
Corporate securities	1,548	(12)	1,425	(75)	2,973	(87)
State and municipal securities	12,208	(224)	-	-	12,208	(224)
Total securities available for sale	$ 45,515	$ (1,025)	$ 4,037	$ (182)	$ 49,552	$ (1,207)

Note 4. Investment Securities, continued

At December 31, 2017, 35 debt securities with unrealized losses had depreciated 2.05 percent from their total amortized cost basis. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, and the financial condition and near-term prospects of the issuer. The relative significance of these and other factors will vary on a case by case basis. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, the results of reviews of the issuer's financial condition and the issuer's anticipated ability to pay the contractual cash flows of the investments. Since the Company intends to hold all of its investment securities until maturity, and it is more likely than not that the Company will not have to sell any of its investment securities before unrealized losses have been recovered, and the Company expects to recover the entire amount of the amortized cost basis of all its securities, none of the securities are deemed other than temporarily impaired at December 31, 2017. Management continues to monitor all of these securities with a high degree of scrutiny. There can be no assurance that the Company will not conclude in future periods that conditions existing at that time indicate some or all of these securities are other than temporarily impaired, which could require a charge to earnings in such periods.

Proceeds from the sales of investment securities available for sale were $8.7 and $55.1 million for the years ended December 31, 2017 and 2016, respectively. Gross realized gains and losses for the years ended December 31 are as follows:

(dollars in thousands)	**2017**	**2016**
Realized gains	$ 257	$ 369
Realized losses	(15)	(5)
	$ 242	$ 364

There were no securities transferred between the available for sale and held to maturity portfolios or other sales of held to maturity securities during the periods presented. In the future management may elect to classify securities as held to maturity based upon such considerations as the nature of the security, the Bank's ability to hold the security until maturity, and general economic conditions.

The scheduled maturities of securities available for sale at December 31, 2017, were as follows:

(dollars in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 729	$ 730
Due after one year through five years	8,435	8,398
Due after five years through ten years	21,371	20,975
Due after ten years	20,803	20,572
	$ 51,338	$ 50,675

Maturities of mortgage backed securities are based on contractual amounts. Actual maturity will vary as loans underlying the securities are prepaid.

Investment securities with amortized cost of approximately $11.2 million at December 31, 2017 and 2016, were pledged as collateral on public deposits and for other purposes as required or permitted by law.

Note 5. Loans Receivable

The major components of loans in the consolidated balance sheets at December 31, 2017 and December 31, 2016 are as follows:

(dollars in thousands)	2017	2016
Commercial & agricultural	$ 25,672	$ 26,086
Commercial mortgage	125,661	128,515
Construction & development	25,475	26,464
Farmland	33,353	33,531
Residential	199,120	187,188
Consumer & other	15,590	10,184
Total loans	424,871	411,968
Allowance for loan losses	(3,453)	(3,420)
Loans, net of allowance for loan losses	$ 421,418	$ 408,548

The major components of loans, net of fair value adjustments, acquired from Cardinal as of July 1, 2016, the acquisition date, are as follows:

(dollars in thousands)	
Commercial & agricultural	$ 15,897
Commercial mortgage	76,968
Construction & development	7,800
Farmland	4,146
Residential	49,609
Consumer & other	3,432
Total loans acquired	$ 157,852

As of the acquisition date, all loans acquired from Cardinal were considered to be performing loans therefore there were no purchased credit impaired loans.

As of December 31, 2017 and 2016, substantially all of the Bank's residential 1-4 family loans were pledged as collateral toward borrowings with the Federal Home Loan Bank.

Note 6. Allowance for Loan Losses and Impaired Loans

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed to be sufficient to provide for estimated loan losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, delinquency levels, actual loss experience, current economic conditions, and detailed analysis of individual loans for which the full collectability may not be assured. The detailed analysis includes methods to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific and general components. The specific component is calculated on an individual basis for larger-balance, non-homogeneous loans, which are considered impaired. A specific allowance is established when the discounted cash flows, collateral value (less disposal costs), or observable market price of the impaired loan is lower than its carrying value. The specific component of the allowance for smaller-balance loans whose terms have been modified in a troubled debt restructuring (TDR) is calculated on a pooled basis considering historical experience adjusted for qualitative factors. These smaller-balance TDRs were collectively evaluated for impairment. The general component covers the remaining loan portfolio, and is based on historical loss experience adjusted for qualitative factors. The appropriateness of the allowance for loan losses on loans is estimated based upon these factors and trends identified by management at the time financial statements are prepared.

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

A provision for loan losses is charged against operations and is added to the allowance for loan losses based on quarterly comprehensive analyses of the loan portfolio. The allowance for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan portfolio. While management has allocated the allowance for loan losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

The following table presents activity in the allowance by loan category and information on the loans evaluated individually for impairment and collectively evaluated for impairment as of December 31, 2017 and December 31, 2016:

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands)	Construction & Development	Farmland	Residential	Commercial Mortgage	Commercial & Agricultural	Consumer & Other	Total
December 31, 2017							
Allowance for loan losses:							
Beginning Balance	$ 319	$ 342	$ 1,841	$ 600	$ 210	$ 108	$ 3,420
Charge-offs	(33)	(34)	(89)	(59)	(27)	(76)	(318)
Recoveries	56	-	23	-	33	22	134
Provision	(103)	50	100	78	66	26	217
Ending Balance	$ 239	$ 358	$ 1,875	$ 619	$ 282	$ 80	$ 3,453
Ending balance: individually evaluated for impairment	$ -	$ 49	$ 42	$ -	$ -	$ -	$ 91
Ending balance: collectively evaluated for impairment	$ 239	$ 309	$ 1,833	$ 619	$ 282	$ 80	$ 3,362
Loans outstanding:							
Ending Balance	$ 25,475	$ 33,353	$ 199,120	$ 125,661	$ 25,672	$ 15,590	$ 424,871
Ending balance: individually evaluated for impairment	$ -	$ 5,069	$ 1,556	$ -	$ -	$ -	$ 6,625
Ending balance: collectively evaluated for impairment	$ 25,475	$ 28,284	$ 197,564	$ 125,661	$ 25,672	$ 15,590	$ 418,246
December 31, 2016							
Allowance for loan losses:							
Beginning Balance	$ 344	$ 435	$ 1,887	$ 578	$ 136	$ 38	$ 3,418
Charge-offs	(20)	-	(84)	(21)	(19)	(70)	(214)
Recoveries	98	59	22	-	8	34	221
Provision	(103)	(152)	16	43	85	106	(5)
Ending Balance	$ 319	$ 342	$ 1,841	$ 600	$ 210	$ 108	$ 3,420
Ending balance: individually evaluated for impairment	$ -	$ 57	$ 184	$ -	$ -	$ -	$ 241
Ending balance: collectively evaluated for impairment	$ 319	$ 285	$ 1,657	$ 600	$ 210	$ 108	$ 3,179
Loans outstanding:							
Ending Balance	$ 26,464	$ 33,531	$ 187,188	$ 128,515	$ 26,086	$ 10,184	$ 411,968
Ending balance: individually evaluated for impairment	$ 580	$ 5,030	$ 1,533	$ 114	$ -	$ -	$ 7,257
Ending balance: collectively evaluated for impairment	$ 25,884	$ 28,501	$ 185,655	$ 128,401	$ 26,086	$ 10,184	$ 404,711

As of December 31, 2017 and December 31, 2016, the Bank had no unallocated reserves included in the allowance for loan losses.

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

Management closely monitors the quality of the loan portfolio and has established a loan review process designed to help grade the quality of the Bank's loan portfolio. The Bank's loan ratings coincide with the "Substandard," "Doubtful" and "Loss" classifications used by federal regulators in their examination of financial institutions. Generally, an asset is considered Substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. Substandard assets include those characterized by the distinct possibility that the insured financial institution will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all the weaknesses inherent in assets classified Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable. Assets classified as Loss are those considered uncollectible, and of such little value that its continuance on the books is not warranted. Assets that do not currently expose the insured financial institutions to sufficient risk to warrant classification in one of the aforementioned categories but otherwise possess weaknesses are designated "Special Mention." Management also maintains a listing of loans designated "Watch". These loans represent borrowers with declining earnings, strained cash flow, increasing leverage and/or weakening market fundamentals that indicate above average risk. As of December 31, 2017 and December 31, 2016, respectively, the Bank had no loans graded "Doubtful" or "Loss" included in the balance of total loans outstanding.

The following table lists the loan grades utilized by the Bank and the corresponding total of outstanding loans in each category as of December 31, 2017 and December 31, 2016:

Credit Risk Profile by Internally Assigned Grades

(dollars in thousands)	Loan Grades				
	Pass	Watch	Special Mention	Substandard	Total
December 31, 2017					
Real Estate Secured:					
Construction & development	$ 24,612	$ 652	$ -	$ 211	$ 25,475
Farmland	23,935	4,895	74	4,449	33,353
Residential	183,543	12,464	200	2,913	199,120
Commercial mortgage	106,102	15,291	1,611	2,657	125,661
Non-Real Estate Secured:					
Commercial & agricultural	22,446	2,057	649	520	25,672
Consumer & other	15,262	328	-	-	15,590
Total	$ 375,900	$ 35,687	$ 2,534	$ 10,750	$ 424,871
December 31, 2016					
Real Estate Secured:					
Construction & development	$ 24,659	$ 902	$ -	$ 903	$ 26,464
Farmland	23,201	5,276	-	5,054	33,531
Residential	170,885	14,081	-	2,222	187,188
Commercial mortgage	105,317	13,449	3,353	6,396	128,515
Non-Real Estate Secured:					
Commercial & agricultural	22,719	2,333	485	549	26,086
Consumer & other	10,018	126	-	40	10,184
Total	$ 356,799	$ 36,167	$ 3,838	$ 15,164	$ 411,968

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

Loans may be placed in nonaccrual status when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Payments received are first applied to principal, and any remaining funds are then applied to interest. Loans are removed from nonaccrual status when they are deemed a loss and charged to the allowance, transferred to foreclosed assets, or returned to accrual status based upon performance consistent with the original terms of the loan or a subsequent restructuring thereof.

The following table presents an age analysis of nonaccrual and past due loans by category as of December 31, 2017 and December 31, 2016:

(dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Still Accruing	Nonaccrual Loans
December 31, 2017								
Real Estate Secured:								
Construction & development	$ -	$ -	$ 227	$ 227	$ 25,248	$ 25,475	$ -	$ 226
Farmland	188	-	308	496	32,857	33,353	-	3,610
Residential	395	334	710	1,439	197,681	199,120	-	1,211
Commercial mortgage	-	-	194	194	125,467	125,661	-	194
Non-Real Estate Secured:								
Commercial & agricultural	70	-	23	93	25,579	25,672	-	94
Consumer & other	2	24	-	26	15,564	15,590	-	-
Total	$ 655	$ 358	$ 1,462	$ 2,475	$ 422,396	$ 424,871	$ -	$ 5,335
December 31, 2016								
Real Estate Secured:								
Construction & development	$ -	$ -	$ 390	$ 390	$ 26,074	$ 26,464	$ -	$ 647
Farmland	343	-	-	343	33,188	33,531	-	3,310
Residential	413	48	19	480	186,708	187,188	-	31
Commercial mortgage	25	227	426	678	127,837	128,515	-	640
Non-Real Estate Secured:								
Commercial & agricultural	67	-	25	92	25,994	26,086	-	31
Consumer & other	5	6	-	11	10,173	10,184	-	5
Total	$ 853	$ 281	$ 860	$ 1,994	$ 409,974	$ 411,968	$ -	$ 4,664

Impaired Loans

A loan is considered impaired when it is probable that the Bank will be unable to collect all contractual principal and interest payments due in accordance with the original or modified terms of the loan agreement. Smaller balance homogenous loans may be collectively evaluated for impairment. Non-homogenous impaired loans are either measured based on the estimated fair value of the collateral less estimated cost to sell if the loan is considered collateral dependent, or measured based on the present value of expected future cash flows if not collateral dependent. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. When the measurement of the impaired loan is less than the recorded investment in the loan, impairment is recognized by creating or adjusting an allocation of the allowance for loan losses and uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Impaired Loans, continued

As of December 31, 2017 and December 31, 2016, respectively, the recorded investment in impaired loans totaled $12.3 million and $13.3 million. The total amount of collateral-dependent impaired loans at December 31, 2017 and December 31, 2016, respectively, was $3.7 million and $4.0 million. As of December 31, 2017 and December 31, 2016, respectively, $3.7 million and $4.4 million of the recorded investment in impaired loans did not have a related allowance. The Bank had $8.6 million and $10.0 million in troubled debt restructured loans included in impaired loans at December 31, 2017 and December 31, 2016, respectively.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Bank considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the estimated collateral value, reasons for the delay, payment record, the amount past due and the number of days past due.

In 2015, management began collectively evaluating performing TDRs with a loan balance of $250,000 or less for impairment. As of December 31, 2017 and December 31, 2016, respectively, $5.7 million and $6.1 million of TDRs included in the following table were evaluated collectively for impairment and were deemed to have $303 thousand and $315 thousand of related allowance.

The following table is a summary of information related to impaired loans as of December 31, 2017 and December 31, 2016:

Impaired Loans

(dollars in thousands)	Recorded Investment[1]	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2017					
With no related allowance recorded:					
Construction & development	$ -	$ -	$ -	$ -	$ -
Farmland	3,422	3,456	-	3,774	10
Residential	300	300	-	300	8
Commercial mortgage	-	-	-	-	-
Commercial & agricultural	-	26	-	27	-
Consumer & other	-	-	-	-	2
Subtotal	3,722	3,782	-	4,101	20
With an allowance recorded:					
Construction & development	361	361	16	718	111
Farmland	1,936	1,936	58	2,224	135
Residential	5,647	5,832	284	6,209	290
Commercial mortgage	602	737	33	1,020	54
Commercial & agricultural	55	55	3	89	13
Consumer & other	-	-	-	2	-
Subtotal	8,601	8,921	394	10,262	603
Totals:					
Construction & development	361	361	16	718	111
Farmland	5,358	5,392	58	5,998	145
Residential	5,947	6,132	284	6,509	298
Commercial mortgage	602	737	33	1,020	54
Commercial & agricultural	55	81	3	116	13
Consumer & other	-	-	-	2	2
Total	$ 12,323	$ 12,703	$ 394	$ 14,363	$ 623

[1] Recorded investment is the loan balance, net of any charge-offs

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Impaired Loans, continued

(dollars in thousands)	Recorded Investment[1]	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2016					
With no related allowance recorded:					
Construction & development	$ 581	$ 581	$ -	$ 840	$ 17
Farmland	3,660	3,660	-	4,170	18
Residential	-	-	-	347	10
Commercial mortgage	114	114	-	115	4
Commercial & agricultural	-	-	-	-	-
Consumer & other	-	-	-	-	1
Subtotal	4,355	4,355	-	5,472	50
With an allowance recorded:					
Construction & development	193	193	10	201	16
Farmland	1,679	1,679	73	1,705	84
Residential	6,138	6,300	423	6,629	302
Commercial mortgage	838	974	44	1,035	39
Commercial & agricultural	113	113	6	155	9
Consumer & other	4	4	-	10	1
Subtotal	8,965	9,263	556	9,735	451
Totals:					
Construction & development	774	774	10	1,041	33
Farmland	5,339	5,339	73	5,875	102
Residential	6,138	6,300	423	6,976	312
Commercial mortgage	952	1,088	44	1,150	43
Commercial & agricultural	113	113	6	155	9
Consumer & other	4	4	-	10	2
Total	$ 13,320	$ 13,618	$ 556	$ 15,207	$ 501

[1] Recorded investment is the loan balance, net of any charge-offs

Troubled Debt Restructuring

A troubled debt restructured loan is a loan for which the Bank, for reasons related to the borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider.

The loan terms which have been modified or restructured due to a borrower's financial difficulty, include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. Troubled debt restructured loans are considered impaired loans.

Note 6. Allowance for Loan Losses and Impaired Loans, continued

Troubled Debt Restructuring, continued

The following table sets forth information with respect to the Bank's troubled debt restructurings as of December 31, 2017 and December 31, 2016:

(dollars in thousands)	TDRs identified during the period			TDRs identified in the last twelve months that subsequently defaulted[1]		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
December 31, 2017						
Construction & development	-	$ -	$ -	-	$ -	$ -
Farmland	2	298	298	-	-	-
Residential	1	48	48	-	-	-
Commercial mortgage	-	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-	-
Consumer & other	-	-	-	-	-	-
Total	3	$ 346	$ 346	-	$ -	$ -

During the twelve months ended December 31, 2017, three loans were modified that were considered to be TDRs. Term concessions only were granted and no additional funds were advanced.

[1] Loans past due 30 days or more are considered to be in default.

(dollars in thousands)	TDRs identified during the period			TDRs identified in the last twelve months that subsequently defaulted[1]		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
December 31, 2016						
Construction & development	-	$ -	$ -	-	$ -	$ -
Farmland	2	144	150	2	144	150
Residential	5	565	588	-	-	-
Commercial mortgage	-	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-	-
Consumer & other	-	-	-	-	-	-
Total	7	$ 709	$ 738	2	$ 144	$ 150

During the twelve months ended December 31, 2016, seven loans were modified that were considered to be TDRs. Term concessions only were granted for seven loans, and additional funds were advanced on two loans to pay real estate taxes, personal taxes, and closing cost. Additional funds were advanced on one loan to pay for equipment repairs.

[1] Loans past due 30 days or more are considered to be in default.

Note 7. Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2017 and 2016, are as follows:

(dollars in thousands)	2017	2016
Land	$ 4,267	$ 4,145
Buildings and improvements	14,950	14,668
Furniture and equipment	10,213	9,634
	29,430	28,447
Less accumulated depreciation	(11,784)	(10,477)
	$ 17,646	$ 17,970

Depreciation expense for the years ended December 31, 2017 and 2016 amounted to $1,315 thousand and $883 thousand respectively.

Note 8. Cash Value of Life Insurance

The Bank is owner and beneficiary of life insurance policies on certain employees and directors. Policy cash values totaled approximately $17.3 million, and $16.9 million at December 31, 2017 and 2016, respectively.

Note 9. Intangible Assets

The following table presents the gross carrying amount and accumulated amortization for the Company's core deposit intangible assets, which are the only identifiable intangible assets subject to amortization. Core deposit intangibles at December 31, 2017 and 2016 are as follows:

(dollars in thousands)	2017	2016
Gross carrying amount	$ 2,469	$ 2,469
Accumulated amortization	424	142
Net book value	$ 2,045	$ 2,327

Amortization expense for the years ended December 31, 2017 and 2016 amounted to $282 thousand and $142 thousand respectively.

Note 10. Deposits

The aggregate amount of time deposits in denominations of more than $250 thousand at December 31, 2017 and 2016 was $13.5 million, and $12.5 million, respectively. At December 31, 2017, the scheduled maturities of all time deposits are as follows:

(dollars in thousands)

2018	$ 63,799
2019	25,183
2020	21,044
2021	22,112
2022	15,587
Total	$ 147,725

Note 11. Short-Term Debt

At December 31, 2017 and 2016 the Bank had no debt outstanding classified as short-term.

At December 31, 2017, the Bank had established unsecured lines of credit of approximately $28.0 million with correspondent banks to provide additional liquidity if, and as needed. In addition, the Bank has the ability to borrow up to approximately $136.5 million from the Federal Home Loan Bank, subject to the pledging of collateral.

Note 12. Long-Term Debt

At December 31, 2017 and 2016 the Bank had no debt outstanding classified as long-term.

Note 13. Financial Instruments

FASB ASC 825, "Financial Instruments", requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value of future cash flows or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of December 31, 2017 and December 31, 2016. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

			Fair Value Measurements		
(dollars in thousands)	**Carrying Amount**	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
December 31, 2017					
Financial Instruments – Assets					
Net Loans	$ 421,418	$ 417,229	$ -	$ 416,426	$ 803
Financial Instruments – Liabilities					
Time Deposits	147,725	144,656	-	144,656	-
December 31, 2016					
Financial Instruments – Assets					
Net Loans	$ 408,548	$ 405,876	$ -	$ 405,410	$ 466
Financial Instruments – Liabilities					
Time Deposits	167,355	165,257	-	165,257	-

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans or foreclosed assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Note 13. Financial Instruments, continued

Fair Value Hierarchy

Under FASB ASC 820, "Fair Value Measurements and Disclosures", the Company groups assets and liabilities 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. These levels are:

> Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
>
> Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
>
> Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques may include the use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. If a loan is identified as individually impaired, management measures impairment in accordance with applicable accounting guidance. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2017, a small percentage of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with accounting standards, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price the Company records the impaired loan as nonrecurring Level 2. When the fair value is based on either an external or internal appraisal and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. Management engages third-party intermediaries to determine the fair market value of these derivative instruments and classifies these instruments as Level 2. Examples of Level 2 derivatives are interest rate swaps, caps and floors. No derivative instruments were held during the years ended December 31, 2017 or 2016.

Note 13. Financial Instruments, continued

Foreclosed Assets

Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price the Company records the foreclosed asset as nonrecurring Level 2. When the fair value of the collateral is based on either an external or internal appraisal and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

Assets Recorded at Fair Value on a Recurring Basis

(dollars in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2017				
Investment securities available for sale				
Mortgage-backed securities	$ 28,154	$ -	$ 28,154	$ -
Corporate securities	2,936	-	2,936	-
State and municipal securities	19,585	-	19,585	-
Total assets at fair value	$ 50,675	$ -	$ 50,675	$ -
December 31, 2016				
Investment securities available for sale				
Government sponsored enterprises	$ 2,209	$ -	$ 2,209	$ -
Mortgage-backed securities	35,202	-	35,202	-
Corporate securities	2,974	-	2,974	-
State and municipal securities	22,155	-	22,155	-
Total assets at fair value	$ 62,540	$ -	$ 62,540	$ -

No liabilities were recorded at fair value on a recurring basis as of December 31, 2017 or 2016. There were no significant transfers between levels during the years ended December 31, 2017 or 2016.

Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets and liabilities that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. No liabilities were recorded at fair value on a nonrecurring basis at December 31, 2017 or 2016. Assets measured at fair value on a nonrecurring basis are included in the table below.

(dollars in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2017				
Impaired loans	$ 803	$ -	$ -	$ 803
Foreclosed assets	-	-	-	-
Total assets at fair value	$ 803	$ -	$ -	$ 803

Note 13. Financial Instruments, continued

Assets Recorded at Fair Value on a Nonrecurring Basis, continued

(dollars in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2016				
Impaired loans	$ 466	$ -	$ -	$ 466
Foreclosed assets	70	-	-	70
Total assets at fair value	$ 536	$ -	$ -	$ 536

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of December 31, 2017 and 2016, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at December 31, 2017	Fair Value at December 31, 2016	Valuation Technique	Significant Unobservable Inputs	General Range of Significant Unobservable Input Values
Impaired Loans	$ 803	$ 466	Appraised Value/Discounted Cash Flows/Market Value of Note	Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell	0 – 10%
Other Real Estate Owned	$ -	$ 70	Appraised Value/Comparable Sales/Other Estimates from Independent Sources	Discounts to reflect current market conditions and estimated costs to sell	0 – 10%

Note 14. Employee Benefit Plans

Prior to the merger, both Grayson National Bank (Grayson) and Bank of Floyd (Floyd) had qualified noncontributory defined benefit pension plans in place which covered substantially all of each bank's employees. The benefits in each plan are primarily based on years of service and earnings. Both Grayson and Floyd plans were amended to freeze benefit accruals for all eligible employees prior to the effective date of the merger. A summary of each plan follows:

Grayson Plan

The following is a summary of the plan's funded status as of December 31:

(dollars in thousands)	2017	2016
Change in benefit obligation		
Benefit obligation at beginning of year	$ 4,783	$ 4,645
Interest cost	191	196
Actuarial (gain) loss	637	227
Benefits paid	(380)	(306)
Settlement (gain) loss	(8)	21
Benefit obligation at end of year	5,223	4,783
Change in plan assets		
Fair value of plan assets at beginning of year	7,894	7,722
Actual return on plan assets	999	478
Benefits paid	(380)	(306)
Fair value of plan assets at end of year	8,513	7,894
Funded status at the end of the year	$ 3,290	$ 3,111

Note 14. Employee Benefit Plans, continued

Grayson Plan, continued

(dollars in thousands)	2017	2016
Amounts recognized in the Balance Sheet		
Plan benefit cost	$ 4,539	$ 4,292
Unrecognized net actuarial loss	(1,249)	(1,181)
Amount recognized in other assets	$ 3,290	$ 3,111
Amounts recognized in accumulated comprehensive income (loss)		
Unrecognized net actuarial loss	$ (1,249)	$ (1,181)
Deferred taxes	262	401
Amount recognized in accumulated comprehensive income (loss), net	$ (987)	$ (780)
Prepaid benefit detail		
Benefit obligation	$ (5,223)	$ (4,783)
Fair value of assets	8,513	7,894
Unrecognized net actuarial loss	1,249	1,181
Prepaid benefit cost	4,539	4,292
Components of net periodic pension cost		
Interest cost	$ 191	$ 196
Expected return on plan assets	(552)	(558)
Recognized net loss due to settlement	86	57
Recognized net actuarial loss	28	10
Net periodic benefit expense	(247)	(295)
Additional disclosure information		
Accumulated benefit obligation	$ 5,223	$ 4,783
Vested benefit obligation	$ 5,223	$ 4,783
Discount rate used for net periodic pension cost	4.00%	4.25%
Discount rate used for disclosure	3.50%	4.00%
Expected return on plan assets	7.00%	7.25%
Rate of compensation increase	N/A	N/A
Average remaining service (years)	13	14

Using the same fair value hierarchy described in Note 11, the fair values of the Company's pension plan assets, by asset category, are as follows:

(dollars in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2017				
Cash equivalents and short term investments	$ -	$ -	$ -	$ -
Mutual funds – equities	4,368	4,368	-	-
Mutual funds – fixed income	4,145	4,145	-	-
Total assets at fair value	$ 8,513	$ 8,513	$ -	$ -
December 31, 2016				
Cash equivalents and short term investments	$ -	$ -	$ -	$ -
Mutual funds – equities	3,969	3,969	-	-
Mutual funds – fixed income	3,925	3,925	-	-
Total assets at fair value	$ 7,894	$ 7,894	$ -	$ -

Note 14. Employee Benefit Plans, continued

Grayson Plan, continued

Estimated Future Benefit Payments

(dollars in thousands)	Pension Benefits
2018	$ 568
2019	49
2020	16
2021	123
2022	225
2023 – 2027	2,689
	$ 3,670

Funding Policy

It has been Bank practice to contribute the maximum tax-deductible amount each year as determined by the plan administrator. As a result of prior year contributions exceeding the minimum requirements, a Prefunding Balance existed as of December 31, 2017 and there is no required contribution for 2018. Based on this we do not anticipate making a contribution to the plan in 2018.

Long-Term Rate of Return

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

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

Asset Allocation

The pension plan's weighted-average asset allocations at December 31, 2017 and 2016, by asset category are as follows:

	2017	2016
Mutual funds – fixed income	49%	50%
Mutual funds – equity	51%	50%
Cash and equivalents	0%	0%
Total	100%	100%

Note 14. Employee Benefit Plans, continued

Grayson Plan, continued

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 50 percent fixed income and 50 percent equities. The Investment Manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance, for the implementation of the Plan's investment strategy. The Investment Manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the Trustee to administer the investments of the Trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the Trust.

Floyd Plan

The Company participates in the Pentegra Defined Benefit Plan for Financial Institutions ("The Pentegra DB Plan"), a tax-qualified defined-benefit pension plan. The Pentegra DB Plan operates as a multi-employer plan for accounting purposes and is a multiple-employer plan under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code. There are no collective bargaining agreements in place that require contributions to the Pentegra DB Plan.

The Pentegra DB Plan is a single plan under Internal Revenue Code Section 413 (C) and, as a result, all of the assets stand behind all of the liabilities. Accordingly, under the Pentegra DB Plan, contributions made by a participating employer may be used to provide benefits to participants of other participating employers.

Funded Status (market value of plan assets divided by funding target) as of July 1,

Source	2017 Valuation Report	2016 Valuation Report
Bank of Floyd Plan	108.63%	109.78%

Employer Contributions

Plan expenses paid by the Company totaled approximately $58 thousand and $56 thousand for the years ended December 31, 2017 and 2016, respectively.

Note 15. Deferred Compensation and Supplemental Executive Retirement Plans

Deferred compensation plans have been adopted for certain executive officers and members of the Board of Directors for future compensation upon retirement. Under plan provisions aggregate annual payments ranging from $1,992 to $37,200 are payable for ten years certain, generally beginning at age 65. Reduced benefits apply in cases of early retirement or death prior to the benefit date, as defined. Liability accrued for compensation deferred under the plan amounts to $312 thousand and $362 thousand at December 31, 2017 and 2016 respectively. Expense charged against income and included in salary and benefits expense was $27 thousand and $31 thousand in 2017 and 2016, respectively. Charges to income are based on changes in present value of future cash payments, discounted at 8 percent, consistent with prior years. Supplemental executive retirement plans for certain executive officers were adopted in 2017. The plans provide for annual payments ranging from $55,000 to $90,000, payable in monthly installments, and continuing for the life of the executive. Reduced benefits apply in cases of early retirement. Expense charged against income and included in salary and benefits expense in 2017 totaled $36 thousand for these supplemental executive retirement plans.

Prior to the merger, the Bank of Floyd had adopted supplemental executive plans to provide benefits for two former members of management. Aggregate annual payments of $69 thousand are payable for 20 years, beginning subsequent to the executive's last day of employment. The liability is calculated by discounting the anticipated future cash flows at 4.00%. The liability accrued for this obligation was $805 thousand at December 31, 2017. Charges to income amounted to approximately $32 thousand and $17 thousand in 2017 and 2016 respectively. These plans are unfunded, however, life insurance has been acquired in amounts sufficient to discharge the obligations of the agreements.

Note 16. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense (benefit) (substantially all Federal) are as follows:

(dollars in thousands)	2017	2016
Current	$ 213	$ 21
Deferred	2,891	1,154
	$ 3,104	$ 1,175

Rate Reconciliation

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense (benefit) included in the statements of income follows:

(dollars in thousands)	2017	2016
Tax at statutory federal rate	$ 1,881	$ 1,222
Tax exempt interest income	(61)	(33)
Tax exempt insurance income	(151)	(163)
State income tax, net of federal benefit	9	16
Merger expenses	4	205
Bargain purchase gain	-	(303)
Merger related NOL adjustment	-	225
Other	(13)	6
Deferred tax asset re-measurement	1,435	-
	$ 3,104	$ 1,175

Deferred Income Tax Analysis

The significant components of net deferred tax assets (all Federal) at December 31, 2017 and 2016 are summarized as follows:

(dollars in thousands)	2017	2016
Deferred tax assets		
Allowance for loan losses	$ 482	$ 652
Acquired loan credit mark	842	1,710
Deferred compensation	335	569
Investment impairment charge recorded directly to stockholders' equity as a component of other comprehensive income	19	497
Minimum pension liability	262	402
Net operating loss carryforward	2,131	4,227
Alternative minimum tax credit carryforward	638	394
Net unrealized losses on securities available for sale	139	296
Nonaccrual interest income	217	358
Other	76	200
	$ 5,141	$ 9,305
Deferred tax liabilities		
Deferred loan origination costs	228	288
Core deposit intangible	433	798
Accrued pension costs	962	1,471
Depreciation	553	875
Accretion of discount on investment securities, net	-	1
	$ 2,176	$ 3,433
Net deferred tax asset	$ 2,965	$ 5,872

Note 16. Income Taxes, continued

On December 22, 2017, the Tax Cuts and Jobs Act was signed into legislation, lowering the corporate income tax rate to 21% effective January 1, 2018 and making many other significant changes to the US income tax code. Under ASC 740, the effects of changes in tax rates and laws are recognized in the period in which the new legislation is enacted. As a result, the Company's income tax expense for the year ended December 31, 2017 includes tax expense from the re-measurement of deferred assets and liabilities totaling $1.4 million.

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with applicable regulations. Tax returns for the years subsequent to 2014 remain subject to examination by both federal and state tax authorities.

Deferred tax assets or liabilities are initially recognized for differences between the financial statement carrying amount and the tax basis of assets and liabilities which will result in future deductible or taxable amounts and operating loss and tax credit carry-forwards. A valuation allowance is then established, as applicable, to reduce the deferred tax asset to the level at which it is "more likely than not" that the tax benefits will be realized. Sources of taxable income that may allow for the realization of tax benefits include (1) taxable income in the current year or prior years that is available through carry-back, (2) future taxable income that will result from the reversal of existing taxable temporary differences, and (3) taxable income generated by future operations. There is no valuation allowance for deferred tax assets as of December 31, 2017 and 2016. The net operating loss of approximately $10.1 million, if not utilized prior to, will begin to expire in 2031. It is management's belief that realization of the deferred tax asset is more likely than not.

Note 17. Commitments and Contingencies

Litigation

In the normal course of business the Bank is involved in various legal proceedings. After consultation with legal counsel, management believes that any liability resulting from such proceedings will not be material to the consolidated financial statements.

Financial Instruments with Off-Balance Sheet Risk

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. A summary of the Bank's commitments at December 31, 2017 and 2016 is as follows:

(dollars in thousands)	**2017**	**2016**
Commitments to extend credit	$ 56,912	$ 54,667
Standby letters of credit	1,106	-
	$ 58,018	$ 54,667

Note 17. Commitments and Contingencies, continued

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

Concentrations of Credit Risk

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. Investments in state and municipal securities involve governmental entities within and outside the Bank's market area. The concentrations of credit by type of loan are set forth in Note 5. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. The Bank's primary focus is toward small business and consumer transactions, and accordingly, it does not have a significant number of credits to any single borrower or group of related borrowers in excess of $5,000,000. The Bank has cash and cash equivalents on deposit with financial institutions which exceed federally insured limits.

Note 18. Regulatory Restrictions

Dividends

The Company's dividend payments are generally made from dividends received from the Bank. Under applicable federal law, the Comptroller of the Currency restricts national bank total dividend payments in any calendar year to net profits of that year, as defined, combined with retained net profits for the two preceding years. The Comptroller also has authority under the Financial Institutions Supervisory Act to prohibit a national bank from engaging in an unsafe or unsound practice in conducting its business. It is possible, under certain circumstances, the Comptroller could assert that dividends or other payments would be an unsafe or unsound practice.

Intercompany Transactions

The Bank's legal lending limit on loans to the Company is governed by Federal Reserve Act 23A, and differs from legal lending limits on loans to external customers. Generally, a bank may lend up to 10 percent of its capital and surplus to its Parent, if the loan is secured. If collateral is in the form of stocks, bonds, debentures or similar obligations, it must have a market value when the loan is made of at least 20 percent more than the amount of the loan, and if obligations of a state or political subdivision or agency thereof, it must have a market value of at least 10 percent more than the amount of the loan. If such loans are secured by obligations of the United States or agencies thereof, or by notes, drafts, bills of exchange or bankers' acceptances eligible for rediscount or purchase by a Federal Reserve Bank, requirements for collateral in excess of the loan amount do not apply. Under this definition, the legal lending limit for the Bank on loans to the Company was approximately $5.7 million at December 31, 2017. No 23A transactions were deemed to exist between the Company and the Bank at December 31, 2017.

Note 18. Regulatory Restrictions, continued

Capital Requirements

The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Effective January 1, 2015, the federal banking regulators adopted rules to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rules required the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets (increased from the prior requirement of 4%); (iii) a total capital ratio of 8% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4% of total assets (unchanged from the prior requirement). When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The 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. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

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

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

Note 18. Regulatory Restrictions, continued

The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital. The Bank's actual capital amounts and ratios are presented in the following table as of December 31, 2017 and 2016. These ratios comply with Federal Reserve rules to align with the Basel III Capital requirements effective January 1, 2015.

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2017						
Total Capital (to risk weighted assets)	$ 56,962	13.14%	$ 34,688	8.00%	$ 43,360	10.00%
Tier 1 Capital (to risk weighted assets)	$ 53,483	12.33%	$ 26,016	6.00%	$ 34,688	8.00%
Common Equity Tier 1 (to risk weighted assets)	$ 53,483	12.33%	$ 19,512	4.50%	$ 28,184	6.50%
Tier 1 Capital (to average total assets)	$ 53,483	9.81%	$ 21,808	4.00%	$ 27,260	5.00%
December 31, 2016						
Total Capital (to risk weighted assets)	$ 53,657	12.72%	$ 33,744	8.00%	$ 42,180	10.00%
Tier 1 Capital (to risk weighted assets)	$ 50,111	11.88%	$ 25,308	6.00%	$ 33,744	8.00%
Common Equity Tier 1 (to risk weighted assets)	$ 50,111	11.88%	$ 18,981	4.50%	$ 27,417	6.50%
Tier 1 Capital (to average total assets)	$ 50,111	9.01%	$ 22,242	4.00%	$ 27,803	5.00%

Note 19. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant stockholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate 2017 and 2016 loan transactions with related parties were as follows:

(dollars in thousands)	**2017**	**2016**
Balance, beginning	$ 5,112	$ 1,741
New loans	1,388	841
Repayments	(1,228)	(695)
Change in relationship	(503)	3,225
Balance, ending	$ 4,769	$ 5,112

The Company has accepted deposits during the ordinary course of business from certain directors and executive officers of the Company and from their affiliates and associates. The total amount of these deposits outstanding was $10.7 million, and $9.5 million at December 31, 2017 and 2016, respectively.

Notes to Consolidated Financial Statements

Note 20. Parent Company Financial Information

Condensed financial information of Parkway Acquisition Corp. is presented as follows:

Balance Sheets
December 31, 2017 and 2016

(dollars in thousands)	2017	2016
Assets		
Cash and due from banks	$ 1,518	$ 1,621
Investment in affiliate bank	55,115	53,168
Other assets	586	677
Total assets	$ 57,219	$ 55,466
Liabilities		
Other liabilities	$ 37	$ -
Stockholders' Equity		
Common stock	-	-
Surplus	26,166	26,166
Retained earnings	32,526	30,654
Accumulated other comprehensive loss	(1,510)	(1,354)
Total stockholders' equity	57,182	55,466
Total liabilities and stockholders' equity	$ 57,219	$ 55,466

Statements of Income
For the years ended December 31, 2017 and 2016

(dollars in thousands)	2017	2016
Income		
Dividends from affiliate bank	$ 803	$ 573
Bargain purchase gain	-	891
Other income	1	7
	804	1,471
Expenses		
Management and professional fees	35	56
Other expenses	36	27
	71	83
Income before tax benefit and equity in undistributed income of affiliate	733	1,388
Federal income tax expense	(161)	(225)
Income before equity in undistributed income of affiliate	572	1,163
Equity in undistributed income of affiliate	1,855	1,255
Net income	$ 2,427	$ 2,418

Note 20. Parent Company Financial Information, continued

Statements of Cash Flows
For the years ended December 31, 2017 and 2016

(dollars in thousands)	2017	2016
Cash flows from operating activities		
Net income	$ 2,427	$ 2,418
Adjustments to reconcile net income to net cash provided by operations:		
Equity in undistributed income of affiliate	(1,855)	(1,255)
Bargain purchase gain	-	(891)
Change in other assets	91	59
Change in other liabilities	37	(85)
Net cash provided by operating activities	700	246
Cash flows from investing activities		
Net decrease in loans	-	1,002
Cash received in business combination	-	822
Net cash provided by investing activities	-	1,824
Cash flows from financing activities		
Cash paid for fractional shares	-	(5)
Dividends paid	(803)	(473)
Net cash used by financing activities	(803)	(478)
Net (decrease) increase in cash and cash equivalents	(103)	1,592
Cash and cash equivalents, beginning	1,621	29
Cash and cash equivalents, ending	$ 1,518	$ 1,621

Note 21. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed the events occurring through the date the consolidated financial statements were issued and, other than what is disclosed below, no subsequent events occurred requiring accrual or disclosure.

On March 1, 2018, Parkway, Skyline, and Great State Bank, a North Carolina state-chartered bank ("GSB") entered into an Agreement and Plan of Merger (the "Merger Agreement") under which Parkway will acquire GSB. The Merger Agreement provides that, upon the terms and subject to the conditions set forth therein, GSB will merge with and into Skyline (the "Merger"), with Skyline as the surviving bank in the Merger. The Merger Agreement was unanimously approved and adopted by the Board of Directors of each of Parkway and GSB. Subject to the terms and conditions of the Merger Agreement, at the effective time of the Merger (the "Effective Time"), GSB shareholders will have the right to receive 1.21 shares of the common stock of Parkway for each share of the common stock of GSB held immediately prior to the Effective Time.

Note 21. Subsequent Events, Continued

In connection with the execution of the Merger Agreement, all of the directors of GSB entered into support and non-competition agreements with Parkway pursuant to which such individuals, in their capacities as shareholders of GSB, have agreed, among other things, to vote their respective shares of common stock in favor to the approval of the Merger Agreement and to certain non-competition and non-solicitation covenants. The Merger Agreement contains customary representations, warranties and covenants of each of Parkway and Skyline and GSB. The completion of the Merger is subject to various closing conditions, including obtaining the requisite approvals of Parkway's and GSB's shareholders and receiving certain regulatory approvals. GSB has also agreed to customary non-solicitation covenants relating to alternative acquisition proposals. The Merger Agreement also provides that, upon termination of the Merger Agreement under specified circumstances, GSB may be required to pay to Parkway a termination fee of $575,000. The merger is currently expected to close in the third quarter of 2018.

Management’s Discussion and Analysis

Management’s Discussion and Analysis of Operations

Overview

Management’s Discussion and Analysis is provided to assist in the understanding and evaluation of Parkway Acquisition Corp’s. financial condition and its results of operations. The following discussion should be read in conjunction with the Company’s consolidated financial statements.

Parkway Acquisition Corp. (“Parkway”) was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell for the purpose of completing a business combination transaction between Grayson Bankshares, Inc. (“Grayson”) and Cardinal Bankshares Corporation (“Cardinal”). On November 6, 2015, Grayson, Cardinal and Parkway entered into an Agreement and Plan of Merger (the “merger agreement”), providing for the combination of the three companies. Terms of the merger agreement called for Grayson and Cardinal to merge with and into Parkway, with Parkway as the surviving corporation (the “Cardinal merger”). The Cardinal merger was completed on July 1, 2016. Grayson is considered the acquiror and Cardinal is considered the acquiree in the transaction for accounting purposes.

Upon completion of the Cardinal merger, the Bank of Floyd, a wholly-owned subsidiary of Cardinal, was merged with and into Grayson National Bank (the “Bank’), a wholly-owned subsidiary of Grayson. The Bank was organized under the laws of the United States in 1900 and now serves the Virginia counties of Grayson, Floyd, Carroll, Wythe, Montgomery and Roanoke, and the surrounding areas through sixteen full-service banking offices and two loan production offices. Effective March 13, 2017, the Bank changed its name to Skyline National Bank. As an FDIC-insured National Banking Association, the Bank is subject to regulation by the Comptroller of the Currency. Parkway is regulated by the Board of Governors of the Federal Reserve System.

For purposes of this annual report on Form 10-K, all information contained herein as of and for periods prior to July 1, 2016 reflects the operations of Grayson prior to the Cardinal merger. Unless this report otherwise indicates or the context otherwise requires, all references to “Parkway” or the “Company” as of and for periods subsequent to July 1, 2016 refer to the combined company and its subsidiary as a combined entity after the Cardinal merger, and all references to the “Company” as of and for periods prior to July 1, 2016 are references to Grayson and its subsidiary as a combined entity prior to the Cardinal merger.

On March 1, 2018, the Company and the Bank entered into an Agreement and Plan of Merger with Great State Bank pursuant to which the Company will acquire Great State Bank. The agreement provides that, upon the terms and subject to the conditions set forth therein, Great State Bank will merge with and into the Bank, with Skyline as the surviving bank in the Merger. Upon completion of the merger, shareholders of Great State bank will receive 1.21 shares of the Company’s common stock for each share of Great State common stock they own. Great State Bank is a Wilkesboro, North Carolina-based bank with branches in Boone, Wilkesboro and Yadkinville, North Carolina and loan production offices in Lenoir and Shelby, North Carolina. As of December 31, 2017, Great State Bank had total assets of $139 million. The proposed merger is expected to be completed in the third quarter of 2018, subject to approval of both companies’ shareholders, regulatory approvals, and other customary closing conditions.

Parkway had net earnings of $2.4 million for 2017 compared to $2.4 million for 2016 and $997 thousand for 2015. Earnings in 2017 and 2016 were impacted significantly by the above mentioned merger activity. Interest income and interest expense increased due to the acquired loans and deposits. Non-recurring merger related expenses totaled approximately $748 thousand in 2017 and $1.5 million in 2016. Earnings in 2017 were also significantly impacted by a nonrecurring charge to income tax expense to reflect the impact of the Tax Cuts and Jobs Act which was signed into law on December 22, 2017. The new legislation reduced tax rates effective January 1, 2018, resulting in a re-measurement of the Company’s deferred tax assets and liabilities. The change in value of the Company’s deferred tax assets was recorded as an addition to 2017 income tax expense of $1.44 million.

Management's Discussion and Analysis

Forward Looking Statements

From time to time, the Company and its senior managers have made and will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be contained in this report and in other documents that the Company files with the Securities and Exchange Commission. Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Also, forward-looking statements can generally be identified by words such as "may," "could," "should," "would," "believe," "anticipate," "estimate," "seek," "expect," "intend," "plan" and similar expressions.

Forward-looking statements provide management's expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond the Company's control that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

- any required increase in our regulatory capital ratios;
- inflation, interest rate levels and market and monetary fluctuations;
- the difficult market conditions in our industry;
- trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;
- applicable laws and regulations and legislative or regulatory changes;
- the timely development and acceptance of new products and services of the Company;
- the willingness of customers to substitute competitors' products and services for the Company's products and services;
- the financial condition of the Company's borrowers and lenders;
- the Company's success in gaining regulatory approvals, when required;
- technological and management changes;
- growth and acquisition strategies;
- the Company's critical accounting policies and the implementation of such policies;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- combining the Company and Great State may be more difficult than we expect, and we may not be able to realize the anticipated benefits and estimated cost savings in the proposed merger;
- regulatory approvals in connection with the proposed merger may not be received, may take longer than expected or may impose conditions that are not presently anticipated or cannot be met;
- the proposed merger may distract our management from their other responsibilities;
- failure to complete the proposed merger could negatively impact us;
- changes in consumer spending and saving habits;
- the strength of the United States economy in general and the strength of the local economies in which the Company conducts its operations; and
- the Company's success at managing the risks involved in the foregoing.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The notes to the audited consolidated financial statements included in the Annual Report for the year ended December 31, 2017 contain a summary of its significant accounting policies. Management believes the Company's policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, such as the recoverability of intangible assets and other-than-temporary impairment of investment securities, involve a higher degree of complexity and require management to make difficult and subjective judgments that often require assumptions or estimates about highly uncertain matters. Accordingly, management considers the policies related to those areas as critical.

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: the first of which requires that losses be accrued when they are probable of occurring and estimable, and the second, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market, and the loan balance.

The allowance for loan losses has three basic components: (**i**) the formula allowance, (**ii**) the specific allowance, and (**iii**) the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, expected cash flows and fair market value of collateral are used to estimate these losses. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Table 1. Net Interest Income and Average Balances (dollars in thousands)

	2017			2016			2015		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Interest-earning assets:									
Interest-bearing deposits	$ 9,611	$ 48	0.50%	$ 9,977	$ 37	0.37%	$ 608	$ 1	0.18%
Federal funds sold	9,703	111	1.14%	9,316	46	0.49%	8,856	18	0.21%
Investment securities	59,210	1,393	2.35%	51,027	1,195	2.34%	62,487	1,495	2.39%
Loans [1, 2]	417,723	20,722	4.96%	325,723	16,284	5.00%	227,650	11,189	4.92%
Total	496,247	22,274		396,043	17,562		299,601	12,703	
Yield on average interest-earning assets			4.49%			4.43%			4.24%
Non interest-earning assets:									
Cash and due from banks	7,145			10,256			6,780		
Premises and equipment	17,852			14,603			11,988		
Interest receivable and other	33,449			22,279			17,125		
Allowance for loan losses	(3,539)			(3,927)			(3,855)		
Unrealized gain/(loss) on securities	(356)			364			55		
Total	54,551			43,575			32,093		
Total assets	$550,798			$439,618			$331,694		
Interest-bearing liabilities:									
Demand deposits	$ 59,485	52	0.09%	$ 42,848	44	0.10%	$ 26,653	21	0.08%
Savings deposits	143,895	342	0.24%	107,546	247	0.23%	75,067	169	0.22%
Time deposits	159,733	1,079	0.68%	132,637	995	0.75%	104,745	1,162	1.11%
Borrowings	37	1	1.93%	11,412	442	3.87%	20,000	874	4.37%
Total	363,150	1,474		294,443	1,728		226,465	2,226	
Cost on average interest-bearing liabilities			0.41%			0.59%			0.98%
Non interest-bearing liabilities:									
Demand deposits	128,356			100,425			73,167		
Interest payable and other	2,351			1,729			1,125		
Total	130,707			102,154			74,292		
Total liabilities	493,857			396,597			300,757		
Stockholder's equity:	56,941			43,021			30,937		
Total liabilities and stockholder's equity	$550,798			$439,618			$331,694		
Net interest income		$20,800			$15,834			$ 10,477	
Net yield on interest-earning assets			4.19%			3.99%			3.50%

[1] Includes nonaccural loans

[2] Interest income includes loan fees

Table 2. Rate/Volume Variance Analysis (dollars in thousands)

	2017 Compared to 2016			2016 Compared to 2015		
	Interest Income/ Expense Variance	Variance Attributable To[(1)] Rate	Volume	Interest Income/ Expense Variance	Variance Attributable To[(1)] Rate	Volume
Interest-earning assets:						
Interest bearing deposits	$ 11	$ 12	$ (1)	$ 36	$ 2	$ 34
Federal funds sold	65	63	2	28	27	1
Investment securities	198	5	193	(300)	(30)	(270)
Loans	4,438	(131)	4,569	5,095	185	4,910
Total	4,712	(51)	4,763	4,859	184	4,675
Interest-bearing liabilities:						
Demand deposits	8	(4)	12	23	6	17
Savings deposits	95	11	84	78	7	71
Time deposits	84	(100)	184	(167)	(432)	265
Borrowings	(441)	(1)	(440)	(432)	(91)	(341)
Total	(254)	(94)	(160)	(498)	(510)	12
Net interest income	$ 4,966	$ 43	$ 4,923	$ 5,357	$ 694	$ 4,663

(1) The variance in interest attributed to both volume and rate has been allocated to variance attributed to volume and variance attributed to rate in proportion to the absolute value of the change in each.

Net Interest Income

Net interest income, the principal source of Company earnings, is the amount of income generated by earning assets (primarily loans and investment securities) less the interest expense incurred on interest-bearing liabilities (primarily deposits used to fund earning assets). Table 1 summarizes the major components of net interest income for the past three years and also provides yields and average balances.

For the year ended December 31, 2017, total interest income increased by $4.7 million compared to the year ended December 31, 2016. As noted above, the Cardinal merger was completed on July 1, 2016; therefore, the operating results for 2016 include only six months of combined earnings along with six months of Grayson earnings prior to the merger. Accordingly, the increases in interest income on loans and investment securities for the year ended December 31, 2017 were due primarily to the increased volume resulting from the merger. The increases in interest income on federal funds sold and interest-bearing deposits in banks were due more to increases in overnight borrowing rates established by the Federal Reserve. Interest expense on deposits increased by $187 thousand in 2017 compared to 2016 as interest expense on acquired deposit balances was partially offset by decreases in deposit rates due to higher-yielding time deposits repricing to lower rates or migrating to lower-yielding non-maturity deposits. Interest on borrowings decreased by $441 thousand due to the repayment of $20.0 million in borrowings in 2016. The effects of changes in volumes and rates on net interest income in 2017 compared to 2016, and 2016 compared to 2015 are shown in Table 2.

The aforementioned factors led to an increase in net interest income of $5.0 million or 31.36% for 2017 as compared to 2016. The net yield on interest-earning assets increased by 20 basis points to 4.19% in 2017 compared to 3.99% in 2016.

Provision for Credit Losses

The allowance for credit losses is established to provide for expected losses in the Company's loan portfolio. Management determines the provision for credit losses required to maintain an allowance adequate to provide for probable losses. Some of the factors considered in making this decision are the levels and collectability of past due loans, volume of new loans, composition of the loan portfolio, and general economic outlook.

The provision for loan losses was $217 thousand for the year ended December 31, 2017, compared to a negative $5 thousand for the year ended December 31, 2016. Asset quality has remained relatively consistent over the past year; therefore, the increase in loan loss provisions from 2016 to 2017 was due primarily to overall growth in the loan portfolio. The reserve for loan losses at December 31, 2017 was approximately 0.81% of total loans, compared to 0.83% at December 31, 2016. Management's estimate of probable credit losses inherent in the acquired Cardinal loan portfolio was reflected as a purchase discount which will be accreted into income over the remaining life of the acquired loans. As of December 31, 2017, the remaining unaccreted discount on the acquired loan portfolio totaled $3.97 million. Management believes the provision and the resulting allowance for loan losses are adequate.

Additional information is contained in Tables 12 and 13, and is discussed in Nonperforming and Problem Assets.

Other Income

Noninterest income consists of revenues generated from a broad range of financial services and activities. The majority of noninterest income is traditionally a result of service charges on deposit accounts including charges for overdrafts and fees charged for non-deposit services. Noninterest income decreased by $342 thousand in 2017 compared to 2016. The decrease was due to the nonrecurring bargain purchase gain of $891 thousand which was recognized in 2016. Without this gain, noninterest income increased by $549 thousand in 2017, due primarily to increases in service charges and fees resulting from additional accounts acquired through the merger with Cardinal. The increase in noninterest income from 2015 to 2016 was also due primarily to the Cardinal merger, as service charges and other account-based fees increased along with the increase in the number of accounts and greater overall deposit balances.

Table 3. Sources of Noninterest Income (dollars in thousands)

	2017	2016	2015
Service charges on deposit accounts	$ 1,326	$ 1,256	$ 1,008
Increase in cash value of life insurance	444	382	290
Mortgage originations fees	293	167	45
Safe deposit box rental	94	78	62
Gain on securities	242	364	97
ATM income	967	750	653
Investment services income	83	133	95
Merchant services income	147	144	127
Bargain purchase gain	-	891	-
Interchange income	304	206	88
Other income	328	199	46
Total noninterest income	$ 4,228	$ 4,570	$ 2,511

Other Expense

The major components of noninterest expense for the past three years are illustrated at Table 4.

Total noninterest expenses increased by $2.5 million, or 14.65% for the year ended December 31, 2017, compared to the year ended December 31, 2016. As noted above, the overall increase in expenses for the comparative periods was due primarily to the effective date of the Cardinal merger as the 2016 expenses reflect only six months of combined operations and six months of Grayson's operating expenses prior to the merger date. Accordingly, salaries and employee benefits increased by $1.7 million due to the increase in the number of employees, and occupancy expenses increased by $268 thousand due to the addition of seven banking facilities. Data processing expense increased by $289 thousand due to the increased accounts and transaction volume. Nonrecurring merger related expenses totaled $748 thousand in 2017, compared to $1.5 million in 2016. The increase in noninterest expense in 2016, compared to 2015, was also due primarily to the Cardinal merger.

Table 4. Sources of Noninterest Expense (dollars in thousands)

	2017	2016	2015
Salaries & wages	$ 8,230	$ 6,772	$ 4,858
Employee benefits	2,053	1,858	1,700
Total personnel expense	10,283	8,630	6,558
Director fees	327	257	173
Occupancy expense	1,083	815	613
Data processing expense	1,177	888	561
Other equipment expense	1,117	1,170	536
FDIC/OCC assessments	426	350	431
Insurance	129	127	111
Professional fees	533	327	179
Advertising	612	208	223
Postage & freight	311	235	148
Supplies	277	159	137
Franchise tax	397	270	172
Telephone	370	279	203
Travel, dues & meetings	414	299	178
ATM expense	388	355	226
Foreclosure expenses	44	79	14
Merger related expenses	748	1,483	498
Other expense	644	885	619
Total noninterest expense	$ 19,280	$ 16,816	$ 11,580

The overhead efficiency ratio of noninterest expense to adjusted total revenue (net interest income plus noninterest income) was 77.03% in 2017, 82.42% in 2016, and 89.16% in 2015. The ratios for 2017 and 2016, without the effect of nonrecurring merger related costs, would have been 74.05% and 75.14%, respectively.

Income Taxes

Income tax expense is based on amounts reported in the statements of income (after adjustments for non-taxable income and non-deductible expenses) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. The deferred tax assets and liabilities represent the future Federal income tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled.

Income tax expense (substantially all Federal) was $3.1 million in 2017, $1.2 million in 2016, and $598 thousand in 2015, resulting in effective tax rates of 56.1%, 32.7%, and 37.5% respectively. The increase in 2017 was due to a one-time charge of $1.4 million to reflect impact of the Tax Cuts and Jobs Act which was signed into law on December 22, 2017. The new legislation reduced tax rates effective January 1, 2018, resulting in a re-measurement of the Company's deferred tax assets and liabilities.

Net deferred tax assets of $3.0 million, after the re-measurement, and $5.9 million are included in other assets at December 31, 2017 and 2016 respectively. At December 31, 2017, net deferred tax assets included $139 thousand of deferred tax assets applicable to unrealized losses on investment securities available for sale, and $262 thousand of deferred tax assets applicable to unfunded projected pension benefit obligations. Accordingly, these amounts were not charged to income but recorded directly to the related stockholders' equity account.

Analysis of Financial Condition

Average earning assets increased 25.30% from 2016 to 2017 due primarily to the Cardinal merger. Total earning assets represented 90.09% of total average assets in 2017 and 90.09% in 2016. The mix of average earning assets changed from 2016 to 2017 as average loans increased by $92.0 million, or 28.24% and average investment securities increased by $8.2 million, or 16.04%.

Table 5. Average Asset Mix (dollars in thousands)

	2017		2016	
	Average Balance	%	Average Balance	%
Earning assets:				
Loans	$ 417,723	75.84%	$ 325,723	74.09%
Investment securities	59,210	10.75%	51,027	11.61%
Federal funds sold	9,703	1.76%	9,316	2.12%
Deposits in other banks	9,611	1.74%	9,977	2.27%
Total earning assets	496,247	90.09%	396,043	90.09%
Non earning assets:				
Cash and due from banks	7,145	1.30%	10,256	2.33%
Premises and equipment	17,852	3.24%	14,603	3.32%
Other assets	33,449	6.07%	22,279	5.07%
Allowance for loan losses	(3,539)	-0.64%	(3,927)	-0.89%
Unrealized gain (loss) on securities	(356)	-0.06%	364	0.08%
Total nonearning assets	54,551	9.91%	43,575	9.91%
Total assets	$ 550,798	100.00%	$ 439,618	100.00%

Average loans for 2017 represented 75.84% of total average assets compared to 74.09% in 2016. Average federal funds sold decreased from 2.12% to 1.76% of total average assets while average investment securities decreased from 11.61% to 10.75% of total average assets over the same time period. The balances of nonearning assets to total average assets was unchanged from 2016 to 2017.

Loans

Average loans totaled $417.7 million over the year ended December 31, 2017. This represents an increase of 28.2% from the average of $325.7 million for 2016. The increase was due primarily to loans acquired from Cardinal. Average loans increased by 43.1% from 2015 to 2016.

The loan portfolio consists primarily of real estate and commercial loans. These loans accounted for 95.67% of the total loan portfolio at December 31, 2017. This is down slightly from the 96.86% that the two categories maintained at December 31, 2016. The amount of loans outstanding by type at December 31 of each of the past five years and the maturity distribution for variable and fixed rate loans as of December 31, 2017 are presented in Tables 6 and 7, respectively.

Table 6. Loan Portfolio Summary (dollars in thousands)

	December 31, 2017		December 31, 2016		December 31, 2015	
	Amount	%	Amount	%	Amount	%
Construction and development	$ 25,475	6.00%	$ 26,464	6.42%	$ 14,493	6.01%
Residential, 1-4 families	170,080	40.03%	160,502	38.96%	112,781	46.76%
Residential, 5 or more families	29,040	6.84%	26,686	6.48%	12,203	5.06%
Farm land	33,353	7.85%	33,531	8.14%	31,512	13.06%
Nonfarm, nonresidential	125,661	29.57%	128,515	31.20%	52,463	21.75%
Total real estate	383,609	90.29%	375,698	91.20%	223,452	92.64%
Agricultural	2,792	0.66%	2,779	0.67%	1,383	0.57%
Commercial	22,880	5.38%	23,307	5.66%	11,399	4.73%
Consumer	5,868	1.38%	5,491	1.33%	3,962	1.64%
Other	9,722	2.29%	4,693	1.14%	1,020	0.42%
Total	$ 424,871	100.00%	$ 411,968	100.00%	$ 241,216	100.00%

	December 31, 2014		December 31, 2013	
	Amount	%	Amount	%
Construction and development	$ 17,158	7.70%	$ 15,269	7.21%
Residential, 1-4 families	110,519	49.56%	99,666	47.08%
Residential, 5 or more families	8,606	3.86%	7,181	3.39%
Farm land	28,570	12.81%	30,074	14.21%
Nonfarm, nonresidential	43,046	19.30%	43,725	20.65%
Total real estate	207,899	93.23%	195,915	92.54%
Agricultural	1,338	0.60%	1,420	0.67%
Commercial	8,954	4.02%	9,346	4.42%
Consumer	3,816	1.71%	4,104	1.94%
Other	984	0.44%	913	0.43%
Total	$ 222,991	100.00%	$ 211,698	100.00%

Table 7. Maturity Schedule of Loans, as of December 31, 2017 (dollars in thousands)

	Real Estate	Agricultural & Commercial	Consumer & Other	Total Amount	Total %
Fixed rate loans:					
Three months or less	$ 7,085	$ 425	$ 2,636	$ 10,146	2.39%
Over three to twelve months	9,875	1,452	429	11,756	2.77%
Over one to five years	51,230	8,827	5,146	65,203	15.35%
Over five years	36,643	1,211	5,379	43,233	10.17%
Total fixed rate loans	$ 104,833	$ 11,915	$ 13,590	$ 130,338	30.68%
Variable rate loans:					
Three months or less	$ 4,261	$ 1,418	$ 64	$ 5,743	1.35%
Over three to twelve months	7,576	4,521	28	12,125	2.85%
Over one to five years	6,091	1,721	58	7,870	1.85%
Over five years	260,848	6,097	1,850	268,795	63.27%
Total variable rate loans	$ 278,776	$ 13,757	$ 2,000	$ 294,533	69.32%
Total loans:					
Three months or less	$ 11,346	$ 1,843	$ 2,700	$ 15,889	3.74%
Over three to twelve months	17,451	5,973	457	23,881	5.62%
Over one to five years	57,321	10,548	5,204	73,073	17.20%
Over five years	297,491	7,308	7,229	312,028	73.44%
Total loans	$ 383,609	$ 25,672	$ 15,590	$ 424,871	100.00%

Interest rates charged on loans vary with the degree of risk, maturity and amount of the loan. Competitive pressures, money market rates, availability of funds, and government regulations also influence interest rates. On average, loans yielded 4.96% in 2017 compared to an average yield of 5.00% in 2016. The decrease in loan yields was due primarily to heightened competition for loans in our markets.

Investment Securities

The Company uses its investment portfolio to provide liquidity for unexpected deposit decreases or loan generation, to meet the Bank's interest rate sensitivity goals, and to generate income.

Management of the investment portfolio has always been conservative with the majority of investments taking the form of purchases of U.S. Treasury, U.S. Government Agencies, U.S. Government Sponsored Enterprises and State and Municipal bonds, as well as investment grade corporate bond issues. Management views the investment portfolio as a source of income, and purchases securities with the intent of retaining them until maturity. However, adjustments are necessary in the portfolio to provide an adequate source of liquidity which can be used to meet funding requirements for loan demand and deposit fluctuations and to control interest rate risk. Therefore, from time to time, management may sell certain securities prior to their maturity. Table 8 presents the investment portfolio at the end of 2017 by major types of investments and contractual maturity ranges. Investment securities in Table 8 may have repricing or call options that are earlier than the contractual maturity date. Yields on tax exempt obligations are not computed on a tax-equivalent basis in Table 8.

The total amortized cost of investment securities decreased by approximately $12.1 million from December 31, 2016 to December 31, 2017, while the average balance of investment securities carried throughout the year increased by approximately $8.2 million from 2016 to 2017. The decrease in total amortized cost came as cash generated from liquidating investment securities was used to fund loan growth. The average yield of the investment portfolio increased to 2.35% for the year ended December 31, 2017 compared to 2.34% for 2016.

Table 8. Investment Securities - Maturity/Yield Schedule (dollars in thousands)

	December 31, 2017							
	In One Year or Less	After One Through Five Years	After Five Through Ten Years	After Ten Years	Book Value 12/31/17	Market Value 12/31/17	Book Value 12/31/16	Book Value 12/31/15
Investment securities:								
U.S. Treasury securities	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 1,534
U.S. Government agencies	-	-	-	-	-	-	-	3
Govt. sponsored enterprises	-	-	-	-	-	-	2,046	15,327
Mortgage-backed securities	-	2,075	13,309	13,397	28,781	28,155	36,021	13,595
Asset-backed securities	-	-	-	-	-	-	-	1,989
Corporate securities	-	-	3,016	-	3,016	2,935	3,061	3,104
State and municipal securities	729	6,361	5,046	7,404	19,540	19,585	22,282	20,673
Total	$ 729	$ 8,436	$ 21,371	$ 20,801	$ 51,337	$ 50,675	$ 63,410	$ 56,225
Weighted average yields:								
Mortgage-backed securities	0.00%	2.05%	2.17%	2.19%	2.17%			
Corporate securities	0.00%	0.00%	3.25%	0.00%	3.25%			
State and municipal securities	2.18%	2.88%	2.92%	2.94%	2.89%			
Total	2.18%	2.68%	2.50%	2.46%	2.51%			

Deposits

The Company relies on deposits generated in its market area to provide the majority of funds needed to support lending activities and for investments in liquid assets. More specifically, core deposits (total deposits less certificates of deposit in denominations of $100,000 or more) are the primary funding source. The Company's balance sheet growth is largely determined by the availability of deposits in its markets, the cost of attracting the deposits, and the prospects of profitably utilizing the available deposits by increasing the loan or investment portfolios. We believe that market conditions have resulted in depositors shopping for deposit rates more than in the past. An increased customer awareness of interest rates adds to the importance of rate management. The Company's management must continuously monitor market pricing, competitor's rates, and the internal interest rate spreads to maintain the Company's growth and profitability. The Company attempts to structure rates so as to promote deposit and asset growth while at the same time increasing overall profitability of the Company. Management has reduced deposit rates in recent years due to relatively weak loan demand and the historically low returns available on alternative investments.

Average total deposits for the year ended December 31, 2017 amounted to $491.5 million, which was an increase of $108.0 million, or 28.17% from 2016. The increase was due primarily to the Cardinal merger, as 2016 averages only included six months of acquired Cardinal deposits. Average core deposits totaled $438.6 million in 2017 representing a 28.05% increase over the $342.5 million in 2016. The percentage of the Company's average deposits that are interest-bearing has remained consistent in recent years at 73.8% in 2015 and 2016, and 73.9% in 2017. Average demand deposits, which earn no interest, increased 27.81% from $100.4 million in 2016 to $128.4 million in 2017. Average deposits for the periods ended December 31, 2017, 2016, and 2015 are summarized in Table 9.

Table 9. Deposit Mix (dollars in thousands)

	December 31, 2017			December 31, 2016		
	Average Balance	% of Total Deposits	Average Rate Paid	Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:						
Interest-bearing DDA accounts	$ 59,485	12.1%	0.09%	$ 42,848	11.2%	0.10%
Money market	42,711	8.7%	0.21%	30,482	7.9%	0.21%
Savings	101,184	20.6%	0.25%	77,064	20.1%	0.24%
Individual retirement accounts	47,045	9.6%	0.91%	41,770	10.9%	1.06%
Small denomination certificates	59,820	12.2%	0.41%	49,942	13.0%	0.52%
Large denomination certificates	52,868	10.7%	0.76%	40,925	10.7%	0.71%
Total interest-bearing deposits	363,113	73.9%	0.41%	283,031	73.8%	0.45%
Noninterest-bearing deposits	128,356	26.1%	0.00%	100,425	26.2%	0.00%
Total deposits	$ 491,469	100.0%	0.30%	$ 383,456	100.0%	0.33%

	December 31, 2015		
	Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:			
Interest-bearing DDA accounts	$ 26,653	9.5%	0.08%
Money market	19,191	6.9%	0.15%
Savings	55,876	20.0%	0.25%
Individual retirement accounts	36,756	13.1%	1.58%
Small denomination certificates	37,592	13.4%	0.63%
Large denomination certificates	30,397	10.9%	1.12%
Total interest-bearing deposits	206,465	73.8%	0.65%
Noninterest-bearing deposits	73,167	26.2%	0.00%
Total deposits	$ 279,632	100.0%	0.48%

The average balance of certificates of deposit issued in denominations of $100,000 or more increased by $11.9 million, or 29.18%, for the year ended December 31, 2017 due to the Cardinal merger. The strategy of management has been to support loan and investment growth with core deposits and not to aggressively solicit the more volatile, large denomination certificates of deposit. Loan growth in 2017 was primarily funded through reductions in interest bearing deposits in banks and investment securities, thus reducing management's reliance on large denomination certificates of deposit for funding purposes. Table 10 provides maturity information relating to certificates of deposit of $100,000 or more at December 31, 2017.

Table 10. Large Denomination Certificate of Deposit Maturities (dollars in thousands)

Analysis of certificates of deposit of $100,000 or more at December 31, 2017:

Remaining maturity of three months or less	$ 8,721
Remaining maturity over three months through six months	5,327
Remaining maturity over six months through twelve months	10,396
Remaining maturity over twelve months	23,652
Total certificates of deposit of $100,000 or more	$ 48,096

Equity

Stockholders' equity totaled $57.18 million at December 31, 2017 compared to $55.5 million at December 31, 2016. The increase in equity resulted from earnings of $2.43 million, less a net change in accumulated other comprehensive losses totaling $156 thousand, and the payment of dividends of $803 thousand. Tangible book value increased from $10.58 per share at December 31, 2016 to $10.98 per share at December 31, 2017.

Effective January 1, 2015, the federal banking regulators adopted rules to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rules required the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets (increased from the prior requirement of 4%); (iii) a total capital ratio of 8% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4% of total assets (unchanged from the prior requirement). When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

Table 11. Bank's Year-end Risk-Based Capital (dollars in thousands)

	2017	2016
Tier 1 Capital	$ 53,483	$ 50,111
Unrealized gains on AFS preferred stock	-	107
Qualifying allowance for loan losses (limited to 1.25% of risk-weighted assets)	3,479	3,439
Total regulatory capital	$ 56,962	$ 53,657
Total risk-weighted assets	$ 433,604	$ 421,801
Tier 1 capital as a percentage of risk-weighted assets	12.3%	11.9%
Common Equity Tier 1 capital as a percentage of risk-weighted assets	12.3%	11.9%
Total regulatory capital as a percentage of risk-weighted assets	13.1%	12.7%
Leverage ratio*	9.8%	9.0%

* Tier 1 capital divided by average total assets for the quarter ended December 31 of each year.

Nonperforming and Problem Assets

Certain credit risks are inherent in making loans, particularly commercial and consumer loans. Management prudently assesses these risks and attempts to manage them effectively. The Bank attempts to use shorter-term loans and, although a portion of the loans have been made based upon the value of collateral, the underwriting decision is generally based on the cash flow of the borrower as the source of repayment rather than the value of the collateral. The Bank also attempts to reduce repayment risk by adhering to internal credit policies and procedures. These policies and procedures include officer and customer limits, periodic loan documentation review and follow up on exceptions to credit policies.

Nonperforming assets at December 31, 2017, 2016, 2015, 2014, and 2013 are analyzed in Table 12.

Table 12. Nonperforming Assets (dollars in thousands)

	2017	2016	2015	2014	2013
Nonperforming loans:					
Nonaccrual loans	$ 5,335	$ 4,664	$ 1,589	$ 4,608	$ 11,858
Restructured loans	7,743	9,239	10,008	10,525	9,216
Loans past due 90 days or more and still accruing	-	-	-	-	83
Total nonperforming loans	13,078	13,903	11,597	15,133	21,157
Foreclosed assets	-	70	408	657	2,197
Total nonperforming assets	$ 13,078	$ 13,973	$ 12,005	$ 15,790	$ 23,354
Total nonperforming loans as a percentage to total loans	3.1%	3.4%	4.8%	6.8%	10.0%
Total nonperforming assets as a percentage to total assets	2.4%	2.5%	3.6%	4.7%	7.0%

Total nonperforming loans were 3.1% and 3.4% of total outstanding loans as of December 31, 2017 and 2016, respectively. The majority of the increase in nonaccrual loans from 2016 to 2017 came in the "residential" category. Nonaccrual loans in this category increased by $1.2 million. Loans are placed in nonaccrual status when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Loans are removed from nonaccrual status when they are deemed a loss and charged to the allowance, transferred to foreclosed assets, or returned to accrual status based upon performance consistent with the original terms of the loan or a subsequent restructuring thereof. Management's ability to ultimately resolve these loans either with or without significant loss will be determined, to a great extent, by general economic and real estate market conditions.

For the years ended December 31, 2017 and 2016, interest income recognized on loans in nonaccrual status was approximately $181 thousand and $44 thousand, respectively. Had these credits been current in accordance with their original terms, the gross interest income for these credits would have been approximately $337 thousand and $167 thousand, respectively for the years ended December 31, 2017 and 2016.

Restructured loans represent troubled debt restructurings (TDRs) that have returned to accrual status after a period of performance in accordance with their modified terms. The decrease in restructured loans from 2016 to 2017 came primarily in the form of principal reductions. A TDR is considered to be successful if the borrower maintains adequate payment performance under the modified terms and is financially stable. The Bank experienced a TDR success rate of approximately 86.1% and 87.1% as of December 31, 2017 and 2016, respectively.

The decrease in foreclosed assets from 2016 to 2017 resulted from the sale of a 1-4 family residential property during the year. Sales and market adjustments of foreclosed assets in 2017 resulted in a net loss of $23 thousand. More information on nonperforming assets can be found in Note 5 of the "Notes to Consolidated Financial Statements" found in the company's 2017 Annual Report.

As of December 31, 2017 and 2016 we had loans with a current principal balance of $38.2 million and $40.0 million rated "Watch" or "Special Mention". The decrease was due primarily to loan risk rating reclassifications. The "Watch" classification is utilized by us when we have an initial concern about the financial health of a borrower that indicate above average risk. We then gather current financial information about the borrower and evaluate our current risk in the credit. After this review we will either move the loan to a higher risk rating category or move it back to its original risk rating. Loans may be left rated "Watch" for a longer period of time if, in management's opinion, there are risks that cannot be fully evaluated without the passage of time, and we want to review it on a more regular basis. Assets that do not currently expose the Bank to sufficient risk to warrant a classification such as "Substandard" or "Doubtful" but otherwise possess weaknesses are designated "Special Mention". Loans rated as "Watch" or "Special Mention" are not considered "potential problem loans" until they are determined by management to be classified as "Substandard". Past due loans are often regarded as a precursor to further credit problems which would lead to future increases in nonaccrual loans or other real estate owned. As of December 31, 2017 loans past due 30-89 days and still accruing totaled $421 thousand compared to $909 thousand at December 31, 2016.

Certain types of loans, such as option ARM products, subprime loans and loans with initial teaser rates, can have a greater risk of non-collection than other loans. The Bank has not offered these types of loans in the past and does not offer them currently. Junior-lien mortgages can also be considered higher risk loans. Our junior-lien portfolio at December 31, 2017 totaled $5.2 million, or 1.2% of total loans. The charge-off rates in this category do not vary significantly from other real estate secured loans in the current year.

The allowance for loan losses is maintained at a level adequate to absorb potential losses. Some of the factors which management considers in determining the appropriate level of the allowance for loan losses are: past loss experience, an evaluation of the current loan portfolio, identified loan problems, the loan volume outstanding, the present and expected economic conditions in general, and in particular, how such conditions relate to the market area that the Bank serves. Bank regulators also periodically review the Bank's loans and other assets to assess their quality. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance. The reserve for loan losses at December 31, 2017 was approximately 0.81% of total loans, compared to 0.83% at December 31, 2016. Management's estimate of probable credit losses inherent in the acquired Cardinal loan portfolio was reflected as a purchase discount which will be accreted into income over the remaining life of the acquired loans. As of December 31, 2017, the remaining unaccreted discount on the acquired loan portfolio totaled $3.97 million. Management believes the provision and the resulting allowance for loan losses are adequate.

To quantify the specific elements of the allowance for loan losses, the Bank begins by establishing a specific reserve for larger-balance, non-homogeneous loans, which have been identified as being impaired. This reserve is determined by comparing the principal balance of the loan with the net present value of the future anticipated cash flows or the fair market value of the related collateral. If the impaired loan is collateral dependent, then any excess in the recorded investment in the loan over the fair value of the collateral that is identified as uncollectible in the near term is charged off against the allowance for loan losses at that time. The bank also collectively evaluates for impairment smaller-balance troubled debt restructurings (TDRs). The specific component of the allowance for smaller-balance TDR loans is calculated on a pooled basis considering historical experience adjusted for qualitative factors. The bank then reviews certain loans in the portfolio and assigns grades to loans which have been reviewed. Loans which are adversely classified are given a specific allowance based on the historical loss experience of similar type loans in each adverse grade with further adjustments for external factors. The remaining portfolio is segregated into loan pools consistent with regulatory guidelines. An allocation is then made to the reserve for these loan pools based on the bank's historical loss experience with further adjustments for external factors. The allowance is allocated according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within the respective categories of loans, although the entire allowance is available to absorb any actual charge-offs that may occur.

The provision for loan losses, net charge-offs, and the resulting allowance for loan losses, are detailed in Table 13. The allocation of the reserve for loan losses is detailed in Table 14.

Table 13. Analysis of the Allowance for Loan Losses (dollars in thousands)

	2017	2016	2015	2014	2013
Allowance for loan losses, beginning	$ 3,420	$ 3,418	$ 4,185	$ 4,591	$ 4,957
Provision for (reduction of) loan losses, added	217	(5)	(187)	294	1,233
Charge-offs:					
Commercial and agricultural	(27)	(19)	(1)	(78)	(129)
Real estate – construction	(33)	(20)	(186)	(268)	(337)
Real estate – mortgage	(182)	(105)	(469)	(599)	(1,110)
Consumer and other	(76)	(70)	(30)	(4)	(90)
Recoveries:					
Commercial and agricultural	33	8	10	15	20
Real estate – construction	56	98	16	17	-
Real estate – mortgage	23	81	23	185	37
Consumer and other	22	34	57	32	10
Net (charge-offs) recoveries	(184)	7	(580)	(700)	(1,599)
Allowance for loan losses, ending	$ 3,453	$ 3,420	$ 3,418	$ 4,185	$ 4,591
Ratio of net charge-offs during the period to average loans outstanding during the period	0.04%	0.00%	0.26%	0.32%	0.77%

Table 14. Allocation of the Allowance for Loan Losses (dollars in thousands)

Balance at the end of the period applicable to:	December 31, 2017 Amount	December 31, 2017 % of Loans to Total Loans	December 31, 2016 Amount	December 31, 2016 % of Loans to Total Loans	December 31, 2015 Amount	December 31, 2015 % of Loans to Total Loans
Commercial and agricultural	$ 282	6.04%	$ 210	6.33%	$ 136	5.30%
Real estate – construction	239	6.00%	319	6.42%	344	6.01%
Real estate – mortgage	2,852	84.29%	2,783	84.78%	2,900	86.63%
Consumer and other	80	3.67%	108	2.47%	38	2.06%
Total	$ 3,453	100.00%	$ 3,420	100.00%	$ 3,418	100.00%

Balance at the end of the period applicable to:	December 31, 2014 Amount	December 31, 2014 % of Loans to Total Loans	December 31, 2013 Amount	December 31, 2013 % of Loans to Total Loans
Commercial and agricultural	$ 154	4.62%	$ 201	5.09%
Real estate – construction	591	7.69%	468	7.21%
Real estate – mortgage	3,388	85.54%	3,826	85.33%
Consumer and other	52	2.15%	96	2.37%
Total	$ 4,185	100.00%	$ 4,591	100.00%

Financial Instruments with Off-Balance Sheet Risk

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. A summary of the Bank's commitments at December 31, 2017 and 2016 is as follows:

	2017	2016
Commitments to extend credit	$ 56,912	$ 54,667
Standby letters of credit	1,106	-
	$ 58,018	$ 54,667

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

Quantitative and Qualitative Disclosure about Market Risk

The principal goals of the Bank's asset and liability management strategy are the maintenance of adequate liquidity and the management of interest rate risk. Liquidity is the ability to convert assets to cash to fund depositors' withdrawals or borrowers' loans without significant loss. Interest rate risk management balances the effects of interest rate changes on assets that earn interest or liabilities on which interest is paid, to protect the Bank from wide fluctuations in its net interest income which could result from interest rate changes.

Management must insure that adequate funds are available at all times to meet the needs of its customers. On the asset side of the balance sheet, maturing investments, loan payments, maturing loans, federal funds sold, and unpledged investment securities are principal sources of liquidity. On the liability side of the balance sheet, liquidity sources include core deposits, the ability to increase large denomination certificates, federal fund lines from correspondent banks, borrowings from the Federal Home Loan Bank, as well as the ability to generate funds through the issuance of long-term debt and equity.

The liquidity ratio (the level of liquid assets divided by total deposits plus short-term liabilities) was 12.4% at December 31, 2017 compared to 17.6% at December 31, 2016. These ratios are considered to be adequate by management.

The Bank uses cash and federal funds sold to meet its daily funding needs. If funding needs are met through holdings of excess cash and federal funds, then profits might be sacrificed as higher-yielding investments are foregone in the interest of liquidity. Therefore management determines, based on such items as loan demand and deposit activity, an appropriate level of cash and federal funds and seeks to maintain that level.

The primary goals of the investment portfolio are liquidity management and maturity gap management. As investment securities mature the proceeds are reinvested in federal funds sold if the federal funds level needs to be increased, otherwise the proceeds are reinvested in similar investment securities. The majority of investment security transactions consist of replacing securities that have been called or matured. The Bank keeps a portion of its investment portfolio in unpledged assets that are less than 60 months to maturity or next repricing date. These investments are a preferred source of funds in that they can be disposed of in most interest rate environments without causing significant damage to that quarter's profits.

Interest rate risk is the effect that changes in interest rates would have on interest income and interest expense as interest-sensitive assets and interest-sensitive liabilities either reprice or mature. Management attempts to maintain the portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing opportunities at levels that will afford protection from erosion of net interest margin, to the extent practical, from changes in interest rates. Table 15 shows the sensitivity of the Bank's balance sheet on December 31, 2017. This table reflects the sensitivity of the balance sheet as of that specific date and is not necessarily indicative of the position on other dates. At December 31, 2017, the Bank appeared to be cumulatively asset-sensitive (interest-earning assets subject to interest rate changes exceeding interest-bearing liabilities subject to changes in interest rates). However, in the one year window liabilities subject to changes in interest rates exceed assets subject to interest rate changes (non asset-sensitive).

Matching sensitive positions alone does not ensure the Bank has no interest rate risk. The repricing characteristics of assets are different from the repricing characteristics of funding sources. Thus, net interest income can be impacted by changes in interest rates even if the repricing opportunities of assets and liabilities are perfectly matched.

Table 15. Interest Rate Sensitivity (dollars in thousands)

	December 31, 2017 Maturities/Repricing				
	1 to 3 Months	4 to 12 Months	13 to 60 Months	Over 60 Months	Total
Interest-Earning Assets:					
Interest bearing deposits	$ 8,739	$ -	$ -	$ -	$ 8,739
Federal funds sold	7,769	-	-	-	7,769
Investments	501	730	26,095	23,349	50,675
Loans	83,056	36,025	226,527	79,263	424,871
Total	$ 100,065	$ 36,755	$ 252,622	$ 102,612	$ 492,054
Interest-Bearing Liabilities:					
Interest-bearing DDA accounts	$ 63,044	$ -	$ -	$ -	$ 63,044
Money market	42,268	-	-	-	42,268
Savings	104,289	-	-	-	104,289
Time deposits	20,061	43,978	83,954	-	147,993
Borrowings	-	-	-	-	-
Total	$ 229,662	$ 43,978	$ 83,954	$ -	$ 357,594
Interest sensitivity gap	$ (129,597)	$ (7,223)	$ 168,668	$ 102,612	$ 134,460
Cumulative interest sensitivity gap	$ (129,597)	$ (136,820)	$ 31,848	$ 134,460	$ 134,460
Ratio of sensitivity gap to total earning assets	-26.3%	-1.5%	34.3%	20.8%	27.3%
Cumulative ratio of sensitivity gap to total earning assets	-26.3%	-27.8%	6.5%	27.3%	27.3%

The Company uses a number of tools to monitor its interest rate risk, including simulating net interest income under various scenarios, monitoring the present value change in equity under the same scenarios, and monitoring the difference or gap between rate sensitive assets and rate sensitive liabilities over various time periods (as displayed in Table 15).

The earnings simulation model forecasts annual net income under a variety of scenarios that incorporate changes in the absolute level of interest rates, changes in the shape of the yield curve, and changes in interest rate relationships. Management evaluates the effect on net interest income and present value equity from gradual changes in rates of up to 400 basis points up or down over a 12-month period. Table 16 presents the Bank's twelve-month forecasts for changes in net interest income and market value of equity resulting from changes in rates of up to 300 basis points up or down, as of December 31, 2017.

Table 16. Interest Rate Risk (dollars in thousands)

	Rate Shocked Net Interest Income and Market Value of Equity						
Rate Change	**-300bp**	**-200bp**	**-100bp**	**0bp**	**+100bp**	**+200bp**	**+300bp**
Net Interest Income:							
Net interest income	$ 19,374	$ 19,448	$ 20,074	$ 20,991	$ 20,923	$ 20,850	$ 20,836
Change	$ (1,617)	$ (1,543)	$ (917)	$ -	$ (68)	$ (141)	$ (155)
Change percentage	-7.70%	-7.35%	-4.37%		-0.32%	-0.67%	-0.74%
Market Value of Equity	$ 85,725	$ 82,261	$ 89,443	$ 95,921	$ 95,870	$ 93,387	$ 90,068

Impact of Inflation and Changing Prices

The consolidated financial statements and the accompanying notes presented elsewhere in this document have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all Company assets and liabilities are monetary in nature, therefore the impact of inflation is reflected primarily in the increased cost of operations. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Table 17. Key Financial Ratios

	2017	2016	2015
Return on average assets	0.44%	0.55%	0.30%
Return on average equity	4.28%	5.62%	3.22%
Dividend payout ratio	33.09%	19.56%	17.24%
Average equity to average assets	10.32%	9.78%	9.33%

Smart
Clever minds create change.

Kind
We're never wrong by doing right.

Young-at-heart
We surprise and delight.

Local
We're from here. We own it.

Inspired
Extraordinary passion drives us.

Nonconforming
We don't do mediocre or status quo.

Energetic
This is contagious.

SkylineNationalBank.com