



### **Our Story**

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.

## 2018 Annual Report

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# Growing Our Bank. Expanding Our Service.

We're putting our mission into action to be a vital part of our communities and an active, supportive neighbor. We're focused on nurturing relationships and creating lifelong partnerships—being a strong advocate and trusted financial partner for the people and businesses we serve. As a community centered bank, we understand that when we give our best, we help others be their best.

## **Skyline Now**

WHEN WE SAY WE'RE SMART, KIND, YOUNG-AT-HEART, LOCAL, INSPIRED, NONCONFORMING AND ENERGETIC, WE MEAN IT.

In 2018, we supported organizations and charities.

full-service banking offices

Our NEARLY community teammates 100 activities participated in

Total S680M

Deposits of \$600 M

full-service branches and 3 loan production offices in North Carolina



(in Alleghany, Ashe, Caldwell, Catawba, Cleveland, Wilkes, Watauga, and Yadkin counties) fu bit ar pri of

full-service branches and 1 loan production office in Virginia



(in the counties of Carroll, Grayson, Floyd, Montgomery, Pulaski, Roanoke, and Wythe; and the independent cities of Galax and Salem)





## Great State Bank and Skyline National Bank

#### BETTER TOGETHER

To take local, community banking to a whole new level, Skyline National Bank and Great State Bank joined forces on July 1, 2018. We expanded our presence into several vibrant North Carolina markets with full-service branches in Wilkesboro, Boone and Yadkinville and loan production offices in Lenoir and Shelby.

Since our partnership, we've committed to delivering *always our best* in these new markets. We do this by providing superior service, valuable guidance and creative solutions that serve our customers extremely well and position them for future success.

### **Our New West Jefferson Branch**

Our commitment to give customers and community always our best reached new heights when we expanded into Ashe County, North Carolina with a new full-service branch in West Jefferson. This significant milestone marks our first new branch opening as Skyline National Bank.

Our branch, which opened on April 19th, features a redesigned interior space that's modern yet personal, allowing for a convenient, efficient and friendly way to meet our customers' financial needs.



#### **Stockholder Information**

#### **Annual Meeting**

The annual meeting of stockholders will be held at The Crossroads Institute, 1117 East Stuart Drive, Galax, Virginia, at 1:00 p.m. on Tuesday, May 21, 2019.

#### **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

#### Stock Transfer Agent

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

**Boone**} 189 Boone Heights Drive, Boone, NC 28607 P} 828/264-4260

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 NC 28694 P 336-489-7811

Whitetop 16303 Highlands Parkway, Whitetop, VA 24292 P 276/388-3811

Wilkesboro 1422 US Highway 421, Wilkesboro, NC 28697 P 336/903-4948

Willis 5598 Floyd Highway South, Willis, VA 24380 P 540/745-4191

Wytheville 420 North 4th Street, Wytheville, VA 24382 P 276/228-6050

Yadkinville 516 Hawthorne Drive, Yadkinville, NC 27055 P 336/849-4194

Blacksburg Loan Production Office 902 South Main Street, Blacksburg, VA 24060 P 540/250-0280

Hickory Loan Production Office 340 10th Avenue Drive NE, Suite 2, Hickory, NC 28601 P 828/228-5150

Lenoir Loan Production Office 545A Harper Avenue, Lenoir, NC 28645 P 828/572-0556

Shelby Loan Production Office 809 Lafayette Street, Shelby, NC 28150 P} 704/466-3674

## Financial Highlights<sup>1</sup>

Summary of Operations	2018	2017	2016	2015	2014
Interest income Interest expense Net interest income Provision for (reduction of) loan losses Other income Other expense Income taxes Net income	\$ 26,186 1,901 24,285 325 4,637 22,857 1,214 \$ 4,526	\$ 22,274	\$ 17,562	\$ 12,703 2,226 10,477 (187) 2,511 11,580 598 \$ 997	\$ 12,996 2,600 10,396 294 2,961 11,902 295 \$ 866
Per Share Data					
Net income Cash dividends declared Book value  Year-end Balance Sheet Summary	\$ .81 .20 12.17	\$ .48 .16 11.39	\$ .60 .12 11.05	\$ .58 .10 17.83	\$ .50 17.43
Loans, net Investment securities Total assets Deposits Stockholders' equity  Selected Ratios	\$ 532,970 45,428 680,284 601,868 75,622	\$ 421,418 50,675 547,961 488,441 57,182	\$ 408,548 62,540 558,856 499.387 55,466	\$ 237,798 56,050 331,760 279,876 30,656	\$ 218,805 69,037 333,064 282,136 29,698
Return on average assets Return on average equity Average equity to average assets	0.75% 7.02% 10.66%	0.44% 4.28% 10.32%	0.55% 5.62% 9.78%	0.30% 3.22% 9.33%	0.26% 2.93% 8.94%

<sup>&</sup>lt;sup>1</sup> In thousands of dollars, except per share data.

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### Parkway Acquisition Corp.

#### Dear Fellow Stockholders:

We are pleased to present the year end 2018 Financial Report for Parkway Acquisition Corp. and Skyline National Bank. 2018 was another busy year for everyone here at Parkway. Highlights included the opening of a new full-service branch in West Jefferson, North Carolina, in April, followed by the completion of our merger with Great State Bank in July and the related information systems conversion in September. We have significantly increased our presence in North Carolina and added a fantastic group of people to the Skyline National Bank family.

Earnings for the year totaled \$4.5 million, despite pre-tax merger related expenses totaling nearly \$2.0 million. Without the merger-related costs, net income for the year would have totaled approximately \$6.2 million, which was consistent with our expectations and demonstrates the solid core earnings potential for our company going forward. Our successful merger with Great State Bank added over \$95 million in loans, \$130 million in deposits, and \$145 million of total assets to our company.

Looking back, it's hard to believe that on June 30, 2016, Grayson Bankshares, Inc, and Grayson National Bank had total assets of just \$317 million, total loans of \$245 million, and total deposits of \$274 million. Now, as of December 31, 2018, a mere 30 months later, Parkway Acquisition Corp. and Skyline National Bank have total assets of \$680 million, total loans of \$536 million, and total deposits of \$602 million. In 2016 we had 10 branches, 1 loan production office, and 109 employees; today we operate with 20 full service branches, 4 loan production offices, and a total of 211 employees. We rebranded our combined company and substantially grew our geographic footprint as well. I wanted to take this opportunity to express my heartfelt gratitude to my fellow managers, our Board of Directors, and every employee of our Bank for the dedication, sacrifice, and effort they have put forth to make this happen. Because of their hard work I believe we are well positioned to grow and prosper in 2019 and beyond.

In mid-March, you should have received your semi-annual dividend of 12 cents per share, an increase of 2 cents from the September 2018 dividend amount. Your Board of Directors will address dividends again in the Fall of 2019. As a reminder, 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, Cardinal, or Great State shares into shares of Parkway. If you need help with this you can stop by any of our branches and we will be glad to assist.

We look forward to seeing you at our 2019 Annual Shareholders' Meeting. The meeting will be held on May 21<sup>st</sup>, at 1:00 pm, at The Crossroads Institute in Galax, VA. As in recent years we also plan to hold a series of smaller, informal shareholder sessions in the weeks leading up to the Annual Meeting. You will receive a postcard soon with a listing of dates and locations for these meetings. We always appreciate the opportunity to visit with our shareholders, listen to your comments, and answer any questions you may have.

Always Our Best,

Blake M. Edwards
President and CEO

Blake Edward



#### **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, 2018 and 2017, 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, 2018 and 2017, 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 29, 2019

## Consolidated Balance Sheets December 31, 2018 and 2017

(dollars in thousands)	2018	2017
Assets		
Cash and due from banks	\$ 8,85	8 \$ 6,367
Interest-bearing deposits with banks	12,15	8,739
Federal funds sold	18,99	
Investment securities available for sale	45,42	-
Restricted equity securities	2,05	1,388
Loans, net of allowance for loan losses of \$3,495 at		
December 31, 2018 and \$3,453 at December 31, 2017	532,97	
Cash value of life insurance	17,41	· ·
Foreclosed assets	75	
Properties and equipment, net	20,68	·
Accrued interest receivable	2,08	·
Core deposit intangible	3,89	
Goodwill	3,19	
Deferred tax assets, net	1,85	
Other assets	9,94	
	<u>\$ 680,28</u>	<u>\$ 547,961</u>
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	\$ 160,16	
Interest-bearing	441,70	
Total deposits	601,86	488,441
Accrued interest payable	8	39 46
Other liabilities	2,70	
	604,66	52 490,779
Commitments and contingencies (Note 17)		
Stockholders' Equity		
Preferred stock, no par value; 5,000,000 shares		
authorized, none issued		-
Common stock, no par value; 25,000,000 shares authorized, 6,213,275 and 5,021,376 issued and outstanding		
at December 31, 2018 and 2017, respectively		
Surplus	41,66	,
Retained earnings	35,92	
Accumulated other comprehensive income (loss)	(1,96	
	75,62	
	\$ 680,28	<u>\$4</u> <u>\$ 547,961</u>

### **Consolidated Statements of Income**

Years ended December 31, 2018 and 2017

(dollars in thousands except share amounts)	2018	2017
Interest income		
Loans and fees on loans	\$ 24,574	\$ 20,722
Interest-bearing deposits with banks	106	48
Federal funds sold	228	111
Interest on taxable securities	1,181	1,302
Dividends	97	91
	26,186	22,274
Interest expense		<u> </u>
Deposits	1,867	1,473
Interest on borrowings	34	1
0	1,901	1,474
Net interest income	24,285	20,800
Provision for loan losses	325	217
Net interest income after		
provision for loan losses	23,960	20,583
Noninterest income		
Service charges on deposit accounts	1,538	1,326
Other service charges and fees	1,840	1,597
Net realized gains on securities	1,040	242
	396	293
Mortgage origination fees Increase in cash value of life insurance		
	433 303	444
Life insurance income		226
Other income	<u>122</u> 4,637	326 4,228
Noninterest expenses	<u> </u>	4,220
Salaries and employee benefits	11,802	10,283
Occupancy and equipment	2,671	2,588
Foreclosed asset expense, net	32	44
Data processing expense	1,353	1,177
FDIC Assessments	231	272
Advertising	569	612
Bank franchise tax	438	397
Director fees	370	327
Professional fees	452	430
Telephone expense	415	370
Core deposit intangible amortization	578	282
Merger related expenses	1,978	748
Other expense	1,968	1,750
Other expense	22,857	19,280
Income before income taxes	5,740	5,531
	·	
Income tax expense related to ordinary operations	1,214	1,669
Income tax expense related to change in tax rate		1,435
Total income tax expense	1,214	3,104
Net income	\$ 4,526	\$ 2,427
Basic earnings per share	\$ 0.81	\$ 0.48
Weighted average shares outstanding	5,622,224	5,021,376
Dividends declared per share	<u>\$ 0.20</u>	<u>\$ 0.16</u>

## Consolidated Statements of Comprehensive Income Years ended December 31, 2018 and 2017

(dollars in thousands)	20	018	201	17
Net Income	\$	4,526	\$	2,427
Other comprehensive income (loss)				
Net change in pension reserve:				
Change in pension reserve during the year		(64)		(67)
Tax related to change in pension reserve		13		23
Unrealized gains (losses) on investment securities available for sale:				
Unrealized gains (losses) arising during the year		(509)		449
Tax related to unrealized (gains) losses		107		(153)
Reclassification of net realized gains during the year		(5)		(242)
Tax related to realized gains		1		82
Total other comprehensive income (loss)		(457)		92
Total comprehensive income	\$	4,069	\$	2,519

## Consolidated Statements of Changes in Stockholders' Equity Years ended December 31, 2018 and 2017

#### (dollars in thousands except share amounts)

(aoana a ono aoana a caope oana a	Commor	Stock		Retained	Accumulated Other Comprehensive	
	Shares		Surplus	<b>Earnings</b>	Loss	Total
Balance, December 31, 2016	5,021,376	\$ -	\$ 26,166	\$ 30,654	\$ (1,354) \$	\$ 55,466
Net income	-	-	=	2,427	-	2,427
Other comprehensive loss	-	-	-	· -	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
Net income	-	_	-	4,526	-	4,526
Other comprehensive income	-	-	-	-	(457)	(457)
Issuance of common stock in connection with acquisition of						
Great State Bank	1,191,899	-	15,495	-	-	15,495
Redemption of fractional shares Issued in acquisition of						
Great State Bank	-	-	(1)		-	(1)
Dividends paid (\$0.20 per share)				(1,123)	)	(1,123)
Balance, December 31, 2018	6,213,275	<u>\$</u> _	<u>\$ 41,660</u>	\$ 35,929	<u>\$ (1,967)</u>	\$ 75,622

## Consolidated Statements of Cash Flows Years ended December 31, 2018 and 2017

Cash flows from operating activities         \$ 4,526         \$ 2,427           Adjustments to reconcile net income         to net cash provided by operations:           Loperciation and amortization         1,187         1,315           Amortization of core deposit intangible         578         282           Accretion of loan discount and deposit premium, net         (1,539)         (1,245)           Provision for loan loss         325         2,891           Net realized gains on securities         (5)         (242)           Accretion of discount on securities, net of         19         (50)           amortization of premiums         521         671           Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         (303)         (444)           Cash value of life insurance         (13)         (5)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         25         (1,604)           Other liabilities         25         (1,604)           Sales	(dollars in thousands)	 2018	2017	
Net income	Cash flows from operating activities			
Adjustments to reconcile net income to net cash provided by operations:   Depreciation and amortization   1,187   1,315   Amortization of core deposit intangible   578   282   Accretion of loan discount and deposit premium, net   (1,539)   (1,245)   Provision for loan loss   325   217   Deferred income taxes   1,589   2,891   Accretion of discount on securities   (5)   (242)   Accretion of discount on securities   (5)   (242)   Accretion of premiums   521   671   amortization of premiums   521   671   Deferred compensation   19   (50)   Net realized gains on foreclosed assets   10   23   (303)   Early of the compensation   19   (50)   Net realized loss on foreclosed assets   10   23   (303)   Early of the compensation   (444)   Early of t		\$ 4,526 \$	2,427	
to net cash provided by operations:  Depreciation and amortization Amortization of core deposit intangible Accretion of loan discount and deposit premium, net Accretion of loan discount and deposit premium, net Deferred income taxes I, 589 Provision for loan discount and deposit premium, net Deferred income taxes I, 589 Actrealized gains on securities Accretion of discount on securities, net of amortization of premiums Securities Accretion of discount on securities, net of amortization of premiums Deferred compensation Securities Accretion of discount on securities, net of amortizated loss on foreclosed assets In 10 Deferred compensation Net realized loss on foreclosed assets In 10 Deferred compensation Changes in assets and liabilities: Cash value of life insurance Accrued interest receivable Accrued interest payable Accrued interest payable Accrued interest payable Other assets Activity in available for sale securities  Activity in available for sale securities: Purchases Activity in available for sale securities  Activity in available for sale securities  Activity in available for sale securities  Purchases of restricted equity securities  Auturities/calls/paydowns Is, 366 As 6,664 Maturities/calls/paydowns Auturities/calls/paydowns Is, 366 Is, 36	Adjustments to reconcile net income		,	
Depreciation and amortization				
Amortization of core deposit intangible		1,187	1,315	
Accretion of loan discount and deposit premium, net   1,539   1,245     Provision for loan loss   325   217     Deferred income taxes   1,589   2,891     Net realized gains on securities   (5)   (242)     Accretion of discount on securities, net of amortization of premiums   521   671     Deferred compensation   19   (50)     Net realized loss on foreclosed assets   10   23     Life insurance income   (303)		578	282	
Deferred income taxes         1,589         2,891           Net realized gains on securities         (5)         (242)           Accretion of discount on securities, net of amortization of premiums         521         671           Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         (444)         (444)           Cash value of life insurance         (434)         (444)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (111)           Other liabilities         25         (1,604)           Net cash provided by operating activities         25         (1,604)           Activity in available for sale securities:         -         (1,914)           Sales         1         -<		(1,539)	(1,245)	
Net realized gains on securities         (5)         (242)           Accretion of discount on securities, net of amortization of premiums         521         671           Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         (434)         (444)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         25         (1,604)           Net ash provided by operating activities         8         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from life insurance contracts         672         -           Proceeds from life in				
Accretion of discount on securities, net of amortization of premiums         521         671           Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         Temperature of the civilian of the contracts of the civilian of the contracts of the civilian of the	Deferred income taxes	1,589	2,891	
Accretion of discount on securities, net of amortization of premiums         521         671           Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         Temperature of the civilian of the contracts of the civilian of the contracts of the civilian of the	Net realized gains on securities	(5)	(242)	
Deferred compensation         19         (50)           Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:		. ,		
Net realized loss on foreclosed assets         10         23           Life insurance income         (303)         -           Changes in assets and liabilities:         (434)         (444)           Cash value of life insurance         (434)         (444)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         25         (1,604)           Net cash provided by operating activities         -         (1,914)           Sales         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination	amortization of premiums	521	671	
Life insurance income         (303)         -           Changes in assets and liabilities:         (434)         (444)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         6,279         98           Cash flows from investing activities           Activity in available for sale securities:         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net decrease in deposits         (16,797)         (10,718)           Repayment of borrowings	Deferred compensation	19	(50)	
Changes in assets and liabilities:         (434)         (444)           Cash value of life insurance         (13)         (5)           Other assets         (210)         (4,127)           Other lassets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         8           Activity in available for sale securities:         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities         (16,797)         (10,718)           Re		10	23	
Cash value of life insurance         (434)         (444)           Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         25         (1,604)           Net cash provided by operating activities         8         6,279         98           Cash flows from investing activities         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from life insurance contracts         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities         (10,797)         <	Life insurance income	(303)	-	
Accrued interest receivable         (13)         (5)           Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         2.5         (1,604)           Net cash provided by operating activities         8         6,279         98           Cash flows from investing activities           Activity in available for sale securities:         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities           Net decrease in deposits         (10,718)         -           Repayment of borrowings	Changes in assets and liabilities:			
Other assets         (210)         (4,127)           Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net cash provided by operating activities         6,279         98           Cash flows from investing activities         8         4           Activity in available for sale securities:         -         (1,914)           Purchases         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities         (16,797)         (10,718)           Repayment of borrowings         (2,000)         -	Cash value of life insurance	(434)	(444)	
Accrued interest payable         3         (11)           Other liabilities         25         (1,604)           Net eash provided by operating activities         6,279         98           Cash flows from investing activities         8           Activity in available for sale securities:         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (142)         (239)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from life insurance contracts         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities           Net decrease in deposits         (16,797)         (10,718)           Repayment of borrowings         (2,000)         -           Cash paid for fractional shares         (1)         -           Dividends paid	Accrued interest receivable	(13)	(5)	
Other liabilities         25         (1.604)           Net cash provided by operating activities         6,279         98           Cash flows from investing activities           Activity in available for sale securities:         (1,914)           Purchases         -         (1,914)           Sales         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (16,785)         (12,070)           Net increase in loans         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from life insurance contracts         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities           Net decrease in deposits         (16,797)         (10,718)           Repayment of borrowings         (2,000)         -           Cash paid for fractional shares         (1)         -           Dividends paid         (1,123)         (	Other assets	(210)	(4,127)	
Net cash provided by operating activities         6,279         98           Cash flows from investing activities           Activity in available for sale securities:         (1,914)           Purchases         18,366         8,664           Maturities/calls/paydowns         5,252         4,893           Purchases of restricted equity securities         (16,785)         (12,070)           Proceeds from life insurance contracts         672         -           Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities         (16,797)         (10,718)           Repayment of borrowings         (2,000)         -           Cash paid for fractional shares         (1)         -           Dividends paid         (1,123)         (803)           Net cash used in financing activities         (19,921)         (11,521)           Net increase (decrease) in cash and cash equivalents         17,132	Accrued interest payable		(11)	
Cash flows from investing activities         Activity in available for sale securities:       -       (1,914)         Purchases       -       (1,914)         Sales       18,366       8,664         Maturities/calls/paydowns       5,252       4,893         Purchases of restricted equity securities       (142)       (239)         Net increase in loans       (16,785)       (12,070)         Proceeds from life insurance contracts       672       -         Proceeds from the sale of foreclosed assets       480       47         Purchases of property and equipment, net of sales       (2,830)       (991)         Cash received in business combination       25,761       -         Net cash provided by (used in) investing activities       30,774       (1,610)         Cash flows from financing activities         Net decrease in deposits       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)	Other liabilities	 25	(1,604)	
Activity in available for sale securities:  Purchases Purchases Sales Sales Sales Maturities/calls/paydowns Soles Purchases of restricted equity securities Purchases of restricted equity securities Soles Purchases of restricted equity securities Net increase in loans Proceeds from life insurance contracts Proceeds from life insurance contracts Proceeds from the sale of foreclosed assets At 80 Purchases of property and equipment, net of sales Cash received in business combination Net cash provided by (used in) investing activities  Cash flows from financing activities Net decrease in deposits Net decrease in deposits Net decrease in deposits Scash paid for fractional shares Ocash paid for fractional shares Soley	Net cash provided by operating activities	 6,279	98	
Activity in available for sale securities:  Purchases Purchases Sales Sales Sales Maturities/calls/paydowns Soles Purchases of restricted equity securities Purchases of restricted equity securities Soles Purchases of restricted equity securities Net increase in loans Proceeds from life insurance contracts Proceeds from life insurance contracts Proceeds from the sale of foreclosed assets At 80 Purchases of property and equipment, net of sales Cash received in business combination Net cash provided by (used in) investing activities  Cash flows from financing activities Net decrease in deposits Net decrease in deposits Net decrease in deposits Scash paid for fractional shares Ocash paid for fractional shares Soley	Cash flows from investing activities			
Sales       18,366       8,664         Maturities/calls/paydowns       5,252       4,893         Purchases of restricted equity securities       (142)       (239)         Net increase in loans       (16,785)       (12,070)         Proceeds from life insurance contracts       672       -         Proceeds from the sale of foreclosed assets       480       47         Purchases of property and equipment, net of sales       (2,830)       (991)         Cash received in business combination       25,761       -         Net cash provided by (used in) investing activities       30,774       (1,610)         Cash flows from financing activities       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)          Cash and cash equivalents, beginning       22,875       35,908				
Maturities/calls/paydowns       5,252       4,893         Purchases of restricted equity securities       (142)       (239)         Net increase in loans       (16,785)       (12,070)         Proceeds from life insurance contracts       672       -         Proceeds from the sale of foreclosed assets       480       47         Purchases of property and equipment, net of sales       (2,830)       (991)         Cash received in business combination       25,761       -         Net cash provided by (used in) investing activities       30,774       (1,610)         Cash flows from financing activities       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)         Cash and cash equivalents, beginning       22,875       35,908	· · · · · · · · · · · · · · · · · · ·	-	(1,914)	
Purchases of restricted equity securities       (142)       (239)         Net increase in loans       (16,785)       (12,070)         Proceeds from life insurance contracts       672       -         Proceeds from the sale of foreclosed assets       480       47         Purchases of property and equipment, net of sales       (2,830)       (991)         Cash received in business combination       25,761       -         Net cash provided by (used in) investing activities       30,774       (1,610)         Cash flows from financing activities       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)          Cash and cash equivalents, beginning       22,875       35,908	Sales	18,366	8,664	
Purchases of restricted equity securities       (142)       (239)         Net increase in loans       (16,785)       (12,070)         Proceeds from life insurance contracts       672       -         Proceeds from the sale of foreclosed assets       480       47         Purchases of property and equipment, net of sales       (2,830)       (991)         Cash received in business combination       25,761       -         Net cash provided by (used in) investing activities       30,774       (1,610)         Cash flows from financing activities       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)          Cash and cash equivalents, beginning       22,875       35,908	Maturities/calls/paydowns	5,252	4,893	
Proceeds from life insurance contracts         672         -           Proceeds from the sale of foreclosed assets         480         47           Purchases of property and equipment, net of sales         (2,830)         (991)           Cash received in business combination         25,761         -           Net cash provided by (used in) investing activities         30,774         (1,610)           Cash flows from financing activities         (16,797)         (10,718)           Repayment of borrowings         (2,000)         -           Cash paid for fractional shares         (1)         -           Dividends paid         (1,123)         (803)           Net cash used in financing activities         (19,921)         (11,521)           Net increase (decrease) in cash and cash equivalents         17,132         (13,033)           Cash and cash equivalents, beginning         22,875         35,908		(142)	(239)	
Proceeds from the sale of foreclosed assets  Purchases of property and equipment, net of sales  Cash received in business combination  Net cash provided by (used in) investing activities  Net decrease in deposits  Net decrease in deposits  Repayment of borrowings  Cash paid for fractional shares  Dividends paid  Net cash used in financing activities  Net increase (decrease) in cash and cash equivalents  Cash and cash equivalents, beginning  480  47  480  47  480  47  480  47  480  47  480  47  480  47  480  47  480  47  480  47  480  480	Net increase in loans	(16,785)	(12,070)	
Purchases of property and equipment, net of sales  Cash received in business combination  Net cash provided by (used in) investing activities  Cash flows from financing activities  Net decrease in deposits  Repayment of borrowings  Cash paid for fractional shares  Dividends paid  Net cash used in financing activities  Net increase (decrease) in cash and cash equivalents  Cash and cash equivalents, beginning  (2,830)  (991)  25,761  -  (10,718)  (10,718	Proceeds from life insurance contracts	672	-	
Cash received in business combination Net cash provided by (used in) investing activities  Cash flows from financing activities  Net decrease in deposits Repayment of borrowings (2,000) Cash paid for fractional shares Dividends paid Net cash used in financing activities Net increase (decrease) in cash and cash equivalents  Cash and cash equivalents, beginning  25,761 - 30,774 (1,610)  (10,718) (10,718) (2,000) - (11,521) (11,521) (11,521) (13,033)	Proceeds from the sale of foreclosed assets	480	47	
Net cash provided by (used in) investing activities 30,774 (1,610)  Cash flows from financing activities  Net decrease in deposits (16,797) (10,718) Repayment of borrowings (2,000) - Cash paid for fractional shares (1) - Dividends paid (1,123) (803) Net cash used in financing activities (19,921) (11,521) Net increase (decrease) in cash and cash equivalents 17,132 (13,033)  Cash and cash equivalents, beginning 22,875 35,908	Purchases of property and equipment, net of sales	(2,830)	(991)	
Cash flows from financing activitiesNet decrease in deposits(16,797)(10,718)Repayment of borrowings(2,000)-Cash paid for fractional shares(1)-Dividends paid(1,123)(803)Net cash used in financing activities(19,921)(11,521)Net increase (decrease) in cash and cash equivalents17,132(13.033)Cash and cash equivalents, beginning22,87535,908	Cash received in business combination	 25,761	<u> </u>	
Net decrease in deposits       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)         Cash and cash equivalents, beginning       22,875       35,908	Net cash provided by (used in) investing activities	 30,774	(1,610)	
Net decrease in deposits       (16,797)       (10,718)         Repayment of borrowings       (2,000)       -         Cash paid for fractional shares       (1)       -         Dividends paid       (1,123)       (803)         Net cash used in financing activities       (19,921)       (11,521)         Net increase (decrease) in cash and cash equivalents       17,132       (13,033)         Cash and cash equivalents, beginning       22,875       35,908	Cash flows from financing activities			
Repayment of borrowings (2,000) - Cash paid for fractional shares (1) - Dividends paid (1,123) (803)  Net cash used in financing activities (19,921) (11,521)  Net increase (decrease) in cash and cash equivalents 17,132 (13,033)  Cash and cash equivalents, beginning 22,875 35,908		(16,797)	(10,718)	
Cash paid for fractional shares  Dividends paid  Net cash used in financing activities Net increase (decrease) in cash and cash equivalents  Cash and cash equivalents, beginning  (1)  (803) (11,521) (11,521) (13,033)  Cash and cash equivalents, beginning			-	
Dividends paid  Net cash used in financing activities Net increase (decrease) in cash and cash equivalents  Cash and cash equivalents, beginning  (1,123) (803) (11,521) (11,521) (13,033)  (22,875) 35,908			-	
Net cash used in financing activities (19,921) (11,521) Net increase (decrease) in cash and cash equivalents 17,132 (13,033)  Cash and cash equivalents, beginning 22,875 35,908			(803)	
Net increase (decrease) in cash and cash equivalents 17,132 (13,033)  Cash and cash equivalents, beginning 22,875 35,908		 		
Cash and cash equivalents, ending $\underline{\$}$ 40,007 $\underline{\$}$ 22,875	Cash and cash equivalents, beginning	 22,875	35,908	
	Cash and cash equivalents, ending	\$ 40,007 \$	22,875	

## Consolidated Statements of Cash Flows Years ended December 31, 2018 and 2017

(dollars in thousands)	2018	2017
Supplemental disclosure of cash flow information Interest paid Taxes paid	\$ 1,858 \$ 135	\$ 1,485 \$ 70
Supplemental disclosure of noncash investing activities  Effect on equity of change in net unrealized loss on available for sale securities  Effect on equity of change in unfunded pension liability  Transfers of loans to foreclosed properties	\$ (406) \$ \$ (51) \$ \$ 1,163	\$ 136 \$ (44) \$ -
Business combinations Assets acquired Liabilities assumed Net assets Goodwill recorded Stock issued to acquire Great State Bank	\$ 145,455 \$\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\	\$ - \$ - \$ - \$ -

#### Note 1. Organization and Summary of Significant Accounting Policies

#### **Organization**

Parkway Acquisition Corp. ("Parkway" or the "Company") was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell company 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 pursuant to which Grayson and Cardinal merged with and into Parkway, with Parkway as the surviving corporation (the "Cardinal 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 Cardinal merger was completed on July 1, 2016. Grayson was considered the acquiror and Cardinal was 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. Effective March 13, 2017, the Bank changed its name to Skyline National Bank.

On March 1, 2018, Parkway entered into a definitive agreement pursuant to which Parkway acquired Great State Bank ("Great State"), based in Wilkesboro, North Carolina. The agreement provided for the merger of Great State with and into the Bank, with the Bank as the surviving bank (the "Great State merger"). The transaction closed and the merger became effective on July 1, 2018. Each share of Great State common stock was converted into the right to receive 1.21 shares of Parkway common stock. The Company issued 1,191,899 shares and recognized \$15.5 million in surplus in the Great State merger. Parkway was considered the acquirer and Great State was considered the acquiree in the transaction for accounting purposes. Pursuant to the Great State merger, the Company acquired \$145.5 million of assets, including \$95.1 million in loans and assumed \$133.0 million in liabilities, including \$130.6 million of deposits, on July 1, 2018. Such amounts include preliminary estimated fair value adjustments, which are subject to change.

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 North Carolina counties of Alleghany, Ashe, Burke, Caldwell, Catawba, Cleveland, Watauga, Wilkes, and Yadkin, and the surrounding areas through twenty full-service banking offices and four loan production offices. As an FDIC-insured national banking association, the Bank is subject to regulation by the Comptroller of the Currency and the FDIC. Parkway is regulated by the Board of Governors of the Federal Reserve System.

#### 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.

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

#### **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.

#### **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.

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

#### Use of Estimates, continued

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.

#### 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 payoff 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.

#### 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 Cardinal 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 Cardinal 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.

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

#### Goodwill and Other Intangible Assets

Goodwill arises from business combinations and is generally determined as the excess of fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquire, over the fair value of the nets assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently in events and circumstances exists that indicate that a goodwill impairment test should be performed. The Company has selected July 1, 2019 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Other intangible assets consist of core deposit intangibles that 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). For the core deposit intangible as a result of the Great State merger, we used an estimated useful life of seven years.

#### Revenue Recognition

On January 1, 2018, we adopted the requirements of Accounting Standards Update ("ASU") 2014-9, *Revenue from Contracts with Customers* ("ASU Topic 606"). The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including deposit related fees, interchange fees, merchant income, and annuity and insurance commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross vs. net). Based on its evaluation, the Company determined that ASU 2014-09 did not materially change the method in which the Company currently classifies certain costs associated with the related revenue streams. The Company adopted ASU 2014-09 and its related amendments on its required effective date of January 1, 2018 utilizing the modified retrospective approach. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

#### 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.

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

#### Income Taxes, continued

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)	An On A	lized Gains d Losses vailable for Securities	 ed Benefit ion Items	Total	
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)	
Balance, December 31, 2017 Other comprehensive income (loss) before	\$	(523)	\$ (987) \$	(1,510)	
reclassifications Amounts reclassified from accumulated		(402)	(51)	(453)	
other comprehensive loss		(4)	<u>-</u>	(4)	
Balance, December 31, 2018	\$	(929)	\$ (1,038) \$	(1,967)	

#### 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.

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

#### 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 13. 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 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.

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 performed an evaluation of our leasing contracts and activities. We have developed our methodology to estimate the right-of use assets and lease liabilities, which is based on the present value of lease payments. At December 31, 2018 future minimum lease payments were approximately \$334 thousand. Based on our evaluation the adoption of the guidance will be immaterial to our financial position, results of operations, and cash flows. There will not be a material change to the timing of expense recognition.

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.

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.

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

#### Recent Accounting Pronouncements, continued

In January 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect 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 February 2018, the FASB amended the Financial Instruments Topic of the Accounting Standards Codification. The amendments clarify certain aspects of the guidance issued in ASU 2016-01. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. All entities may early adopt these amendments for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted ASU 2016-01. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2018, the FASB updated the Debt Securities and the Regulated Operations Topics of the Accounting Standards Codification. The amendments incorporate into the Accounting Standards Codification recent SEC guidance which was issued in order to make the relevant interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The amendments were effective upon issuance. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2018, the FASB updated the Income Taxes Topic of the Accounting Standards Codification. The amendments incorporate into the Accounting Standards Codification recent SEC guidance related to the income tax accounting implications of the Tax Cuts and Jobs Act. The amendments were effective upon issuance. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2018, the FASB amended the Financial Services—Depository and Lending Topic of the Accounting Standards Codification to remove outdated guidance related to Circular 202. The amendments were effective upon issuance and did not have a material effect on the financial statements.

In July 2018, the FASB amended the Leases Topic of the Accounting Standards Codification to make narrow amendments to clarify how to apply certain aspects of the new leases standard. The amendments are effective for reporting periods beginning after December 15, 2018. The Company does not expect these amendments to have a material effect on its financial statements.

In July 2018, the FASB amended the Leases Topic of the Accounting Standards Codification to give entities another option for transition and to provide lessors with a practical expedient. The amendments will be effective for the Company for reporting periods beginning after December 15, 2018. The Company does not expect these amendments to have a material effect on its financial statements.

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

#### Recent Accounting Pronouncements, continued

In August 2018, the FASB amended the Fair Value Measurement Topic of the Accounting Standards Codification. The amendments remove, modify, and add certain fair value disclosure requirements based on the concepts in the FASB Concepts Statement, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this ASU and delay adoption of the additional disclosures until their effective date. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2018, the FASB amended the Intangibles—Goodwill and Other Topic of the Accounting Standards Codification to align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internaluse software. The amendments will be effective for the Company for fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In October 2018, the FASB amended the Derivatives and Hedging Topic of the Accounting Standards Codification to expand the list of U.S. benchmark interest rates permitted in the application of hedge accounting. The amendments will be effective for the Company for fiscal years 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 2018, the FASB amended the Collaborative Arrangements Topic of the Accounting Standards Codification to clarify the interaction between the guidance for certain collaborative arrangements and the new revenue recognition financial accounting and reporting standard. The amendments will be effective for the Company for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In December 2018, the FASB issued guidance that providing narrow-scope improvements for lessors, that provides relief in the accounting for sales, use and similar taxes, the accounting for other costs paid by a lessee that may benefit a lessor, and variable payments when contracts have lease and non-lease components. The amendments will be effective for the Company for reporting 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.

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, 2018, Parkway completed its merger with Great State as discussed above in Note 1. Parkway is considered the acquiring entity in this business combination for accounting purposes. Under the terms of the merger agreement, each share of Great State common stock was converted to 1.21 shares of common stock of Parkway which resulted in the issuance of 1,191,899 shares of Parkway stock in the merger. The Company engaged a third party to calculate fair values of all assets and liabilities acquired in the transaction. These valuations are not final and may be refined for up to one year following the merger date.

#### Note 2. Business Combinations, continued

The following table presents the Great State assets acquired and liabilities assumed as of July 1, 2018 as well as the related fair value adjustments and determination of goodwill.

(dollars in thousands)		Reported by reat State	 air Value justments		Reported by Parkway
<u>Assets</u>			 		 
Cash and cash equivalents	\$	25,761	\$ -	-	\$ 25,761
Investment securities		19,630	(229)	(a)	19,401
Restricted equity securities		523	-	-	523
Loans		97,549	(2,441)	(b)	95,108
Allowance for loan losses		(1,436)	1,436	(c)	-
Property and equipment		1,207	189	(d)	1,396
Intangible assets		-	2,425	(e)	2,425
Accrued interest receivable		334	-	-	334
Other assets		599	 <u>(92</u> )	(f)	 507
Total assets acquired	\$	144,167	\$ 1,288		\$ 145,455
<u>Liabilities</u>					
Deposits	\$	129,611	\$ 940	(g)	\$ 130,551
Borrowings		2,000	-	-	2,000
Accrued interest payable		40	-	-	40
Other liabilities		352	 17	(h)	 369
Total liabilities acquired	\$	132,003	\$ 957		\$ 132,960
Net assets acquired					12,495
Elimination of Company's existing investment is	n Great S	State			198
Stock consideration					15,495
Goodwill					\$ 3,198

#### **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 Great State'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 = 21%).
- (g) Estimated fair value adjustment to time deposits based on the Company's third party valuation report on deposits assumed.
- (h) 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 Great State have been recorded at their estimated fair values and added to those of Parkway for periods following the merger date. Valuations of acquired Great State assets and liabilities may be refined 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 FASB 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.

In determining the fair values of acquired loans without evidence of credit deterioration at the date of acquisition, management includes (i) no carryover of any previously recorded allowance for loan losses and (ii) an adjustment of the unpaid principal balance to reflect an appropriate market rate of interest, given the risk profile and grade assigned to each loan. This adjustment is then accreted into earnings as a yield adjustment, using the effective yield method, over the remaining life of each loan.

To the extent that current information indicates it is probable that the Company will collect all amounts according to the contractual terms thereof, such loan is not considered impaired and is not considered in the determination of the required allowance for loan losses. To the extent that current information indicates it is probable that the Company will not be able to collect all amounts according to the contractual terms thereon, such loan is considered impaired and is considered in the determination of the required level of allowance for loan and lease losses.

Subsequent to the acquisition date, increases in cash flows expected to be received in excess of the Company's initial estimates are reclassified from nonaccretable difference to accretable yield and are accreted into interest income on a level-yield basis over the remaining life of the loan. Decreases in cash flows expected to be collected are recognized as impairment through the provision for loan losses.

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

The table below presents supplemental pro forma information as if the Great State acquisition had occurred at the beginning of the earliest period presented, which was January 1, 2017. 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 \$2.0 million and \$748 thousand are included in the Company's consolidated statements of income for the years ended December 31, 2018 and 2017 and are not included in the pro forma statements below.

		Year Ended December 31,			
	2018			2017	
	J)	Jnaudited)	J)	Unaudited)	
Net interest income	\$	23,956	\$	21,279	
Net income (a)	\$	4,266	\$	2,743	
Basic and diluted weighted average shares outstanding (b)		6,213,275		6,213,275	
Basic and diluted earnings per common share	\$	0.69	\$	0.44	

- (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 Great State acquisition as of the earliest reporting date.

It is impractical to disclose the net interest income, non-interest income, and net income of Great State from the acquisition date of July 1, 2018 through December 31, 2018 due to the system conversion that occurred on September 7, 2018, which resulted in the combining of the operations of Great State into Parkway.

#### 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 \$6.3 million and \$3.6 million for the periods including December 31, 2018 and 2017, 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
<u>2018</u>						
Available for sale:						
U.S. Government Agencies	\$ 244	\$ 1	\$	-	\$	245
Mortgage-backed securities	25,627	1		(865)		24,763
Corporate securities	2,970	-		(181)		2,789
State and municipal securities	 17,764	 31		(164)		17,631
	\$ 46,605	\$ 33	\$	(1,210)	\$	45,428
<u>2017</u>	_	 _		_		_
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

Restricted equity securities were \$2.1 million and \$1.4 million at December 31, 2018 and 2017, respectively. Restricted equity securities consist of investments in stock of the Federal Home Loan Bank of Atlanta (FHLB), CBB Financial Corp., 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 CBB Financial Corp. 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, 2018 and 2017.

	Le	Less Than 12 Months 12 Months or More							<b>Total</b>			
(dollars in thousands)		Fair Value		realized Josses	Fair Value	-	realized Losses	Fair Value		realized Losses		
<u>2018</u>												
Available for sale:												
Mortgage-backed securities	\$	450	\$	(1) \$	24,227	\$	(864) \$	24,677	\$	(865)		
Corporate securities		-		-	2,789		(181)	2,789		(181)		
State and municipal securities	_	5,518		(19)	6,834		(145)	12,352		(164)		
Total securities available for sale	\$	5,968	\$	(20) \$	33,850	\$	(1,190) \$	39,818	\$	(1,210)		
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)		

#### Note 4. Investment Securities, continued

At December 31, 2018, 46 debt securities with unrealized losses had depreciated 2.95 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, 2018. 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 \$18.4 and \$8.7 million for the years ended December 31, 2018 and 2017, respectively. Gross realized gains and losses for the years ended December 31 are as follows:

(dollars in thousands)	201	.8	2017			
Realized gains	\$	9 \$	257			
Realized losses		<u>(4</u> )	(15)			
	\$	5 \$	242			

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, 2018, were as follows:

(dollars in thousands)	Amortized Fair Cost Value						
Due in one year or less	\$	703	\$	701			
Due after one year through five years		15,030		14,766			
Due after five years through ten years		15,571		14,943			
Due after ten years		15,301		15,018			
·	\$	46,605	\$	45,428			

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 \$13.9 million and \$11.2 million at December 31, 2018 and 2017 respectively, 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, 2018 and December 31, 2017 are as follows:

(dollars in thousands)	2018			2017		
Construction & development	\$	33,449	\$	25,475		
Farmland		33,291		33,353		
Residential		235,689		199,120		
Commercial mortgage		176,192		125,661		
Commercial & agricultural		37,491		25,672		
Consumer & other		20,353	-	15,590		
Total loans		536,465		424,871		
Allowance for loan losses		(3,495)	-	(3,453)		
Loans, net of allowance for loan losses	\$	532,970	\$	421,418		

The major components of loans, net of fair value adjustments, acquired from Great State Bank as of July 1, 2018, the acquisition date, are as follows:

#### (dollars in thousands)

Construction & development	\$ 7,496
Farmland	720
Residential	26,006
Commercial mortgage	47,953
Commercial & agricultural	11,793
Consumer & other	 1,140
Total loans acquired	\$ 95,108

As of December 31, 2018 and 2017, 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, 2018 and December 31, 2017:

#### Allowance for Loan Losses and Recorded Investment in Loans

	Construction				Commercial	C	
(dollars in thousands)	& Development	Farmland	Residential	Commercial Mortgage	& Agricultural	Consumer & Other	Total
<u>December 31, 2018</u> Allowance for loan losses:	Development	Tarmanu	Kesidentiai	Williage	Agricultural	a one	Total
Beginning Balance	\$ 239				*	* ***	3,453
Charge-offs	(20		(11)	,	,	. ,	(477)
Recoveries	-				9		194
Provision	27	(7			13 © 201	151	325
Ending Balance	<u>\$ 246</u>	<u>\$ 385</u>	\$ 1,807	<u>\$ 682</u>	<u>\$ 281</u>	<u>\$ 94</u> <u>\$</u>	3,495
Ending balance: individually evaluated for impairment	\$ -	\$ 29	<u>\$ 12</u>	\$ -	\$ -	<u>\$ - \$</u>	41
Ending balance: collectively							
evaluated for impairment	\$ 246	\$ 356	\$ 1,795	<u>\$ 682</u>	<u>\$ 281</u>	<u>\$ 94</u> <u>\$</u>	3,454
Loans outstanding: Ending Balance	\$ 33,449	\$ 33,291	\$ 235,689	\$ 176,192	\$ 37,491	\$ 20,353 \$	536,465
Ending balance: individually	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	000,.00
evaluated for impairment	\$ -	\$ 4,552	\$ 1,018	<u>\$</u>	<u>\$</u>	<u>\$</u>	5,570
Ending balance: collectively evaluated for impairment	<u>\$ 33,449</u>	\$ 28,739	234,671	\$ 176,192	<u>\$ 37,491</u>	\$ 20,353 \$	530,895
December 31, 2017 Allowance for loan losses:							
Beginning Balance	\$ 319	\$ 342	2 \$ 1,841	\$ 600	\$ 210	\$ 108 \$	3,420
Charge-offs	(33	) (34	(89	) (59)	(27)	(76)	(318)
Recoveries	56	-	- 23	-	33	22	134
Provision	(103				66	26	217
Ending Balance	<u>\$ 239</u>	<u>\$ 358</u>	\$ 1,875	<u>\$ 619</u>	<u>\$ 282</u>	<u>\$ 80</u> <u>\$</u>	3,453
Ending balance: individually	¢.	<b>6</b> 40		Ф	Φ.	Φ	0.1
evaluated for impairment Ending balance: collectively	<u> </u>	\$ 49	\$ 42	<u> </u>	<u>\$</u>	<u>\$</u> - <u>\$</u>	91
evaluated for impairment	<u>\$ 239</u>	\$ 309	\$ 1,833	\$ 619	<u>\$ 282</u>	<u>\$ 80</u> <u>\$</u>	3,362
Loans outstanding: Ending Balance	<u>\$ 25,475</u>	\$ 33,353	\$ 199,120	<u>\$ 125,661</u>	<u>\$ 25,672</u>	<u>\$ 15,590</u> <u>\$</u>	424,871
Ending balance: individually evaluated for impairment	<u>\$</u> -	\$ 5,069	\$ 1,556	<u>\$</u>	\$ -	<u>\$ - \$</u>	6,625
Ending balance: collectively evaluated for impairment	\$ 25,475	\$ 28,284	\$ 197,564	<u>\$ 125,661</u>	<u>\$ 25,672</u>	<u>\$ 15,590</u> <u>\$</u>	418,246

As of December 31, 2018 and December 31, 2017, 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, 2018 and December 31, 2017, 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, 2018 and December 31, 2017:

#### Credit Risk Profile by Internally Assigned Grades

				Loan (	Gra	ades				
(dollars in thousands)	Pass			Watch		Special Mention	Substandard		 Total	
<b>December 31, 2018</b>										
Real Estate Secured:										
Construction & development	\$	31,237	\$	2,044	\$	147	\$	21	\$ 33,449	
Farmland		23,250		4,933		750		4,358	33,291	
Residential		213,670		18,794		299		2,926	235,689	
Commercial mortgage		148,179		23,468		1,212		3,333	176,192	
Non-Real Estate Secured:										
Commercial & agricultural		33,537		2,908		70		976	37,491	
Consumer & other		18,975		1,364		_		14	 20,353	
Total	\$	468,848	\$	53,511	\$	2,478	\$	11,628	\$ 536,465	
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	

#### 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, 2018 and December 31, 2017:

(dollars in thousands)	Days Due	60-89 Days Past Due	0	00 Days or More Past Due	_1	Total Past Due		Current	Total Loans	90+ Days Past Due and Still Accruing		naccrual Loans
<u>December 31, 2018</u>												
Real Estate Secured:												
Construction & development	\$ 29	•	- \$		\$	29		33,420	\$ 33,449	\$	- \$	-
Farmland	71	100		989		1,160		32,131	33,291		-	3,914
Residential	762	145	,	241		1,148		234,541	235,689		-	653
Commercial mortgage	-	-		604		604		175,588	176,192		-	740
Non-Real Estate Secured:												
Commercial & agricultural	7	-		264		271		37,220	37,491		-	264
Consumer & other	 12	18	<u> </u>	8	_	38	_	20,315	 20,353			8
Total	\$ 881	\$ 263	\$	2,106	\$	3,250	\$	533,215	\$ 536,465	\$	<u>\$</u>	5,579
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	ļ	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			<u>-</u>
Total	\$ 655	\$ 358	\$	1,462	\$	2,475	\$	422,396	\$ 424,871	\$	- \$	5,335

#### **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, 2018 and December 31, 2017, respectively, the recorded investment in impaired loans totaled \$10.3 million and \$12.3 million. The total amount of collateral-dependent impaired loans at December 31, 2018 and December 31, 2017, respectively, was \$2.8 million and \$3.7 million. As of December 31, 2018 and December 31, 2017, respectively, \$3.4 million and \$3.7 million of the recorded investment in impaired loans did not have a related allowance. The Bank had \$7.3 million and \$8.6 million in troubled debt restructured loans included in impaired loans at December 31, 2018 and December 31, 2017, 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, 2018 and December 31, 2017, respectively, \$4.7 million and \$5.7 million of TDRs included in the following table were evaluated collectively for impairment and were deemed to have \$259 thousand and \$303 thousand of related allowance.

The following table is a summary of information related to impaired loans as of December 31, 2018 and December 31, 2017:

#### **Impaired Loans**

(dollars in thousands)	Recorded Investment <sup>1</sup>	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	
<b>December 31, 2018</b>						
With no related allowance recorded:						
Construction & development	*	\$ -	\$ -	*	\$ -	
Farmland	3,284	3,284	-	3,523	23	
Residential	85	85	-	448	13	
Commercial mortgage	-	-	-	-	-	
Commercial & agricultural	-	24	-	-	-	
Consumer & other						
Subtotal	3,369	3,393		3,971	36	
With an allowance recorded:						
Construction & development	69	69	4	306	11	
Farmland	1,539	1,539	38	1,568	86	
Residential	5,005	5,162	241	5,348	266	
Commercial mortgage	275	358	15	522	27	
Commercial & agricultural	37	37	2	47	3	
Consumer & other	4	4		4		
Subtotal	6,929	7,169	300	7,795	393	
Totals:						
Construction & development	69	69	4	306	11	
Farmland	4,823	4,823	38	5,091	109	
Residential	5,090	5,247	241	5,796	279	
Commercial mortgage	275	358	15	522	27	
Commercial & agricultural	37	61	2	47	3	
Consumer & other	4	4		4		
Total	<u>\$ 10,298</u>	\$ 10,562	\$ 300	<u>\$ 11,766</u>	<u>\$ 429</u>	

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 <sup>1</sup>	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	
<b>December 31, 2017</b>						
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	<u>-</u>	
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	<del>_</del>			2	2	
Total	\$ 12,323	\$ 12,703	\$ 394	<u>\$ 14,363</u>	<u>\$ 623</u>	

<sup>&</sup>lt;sup>1</sup> 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. The Bank had \$7.3 million and \$8.6 million in troubled debt restructured loans at December 31, 2018 and December 31, 2017, respectively. 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, 2018 and December 31, 2017:

	TDRs ide	ntified during t	he period	TDRs identified in the last twelve months that subsequently defaulted <sup>(1)</sup>							
(dollars in thousands)	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, 2018											
Construction & development	-	\$ -	\$ -	-	\$ -	\$ -					
Farmland	-	-	-	-	-	-					
Residential	2	80	95	-	-	-					
Commercial mortgage	-	-	-	-	-	-					
Commercial & agricultural	-	-	-	-	-	-					
Consumer & other	1	5	4								
Total	3	<u>\$ 85</u>	<u>\$ 99</u>		<u>\$</u>	<u>\$</u>					

During the twelve months ended December 31, 2018, three loans were modified that were considered to be TDRs. Term concessions were granted and additional funds were advanced for legal expenses and property taxes. No TDRs identified in the last twelve months subsequently defaulted in the year ended December 31, 2018.

<sup>(1)</sup> Loans past due 30 days or more are considered to be in default.

				TDRs identified in the last twelve		
	TDRs identified during the period			months that subsequently defaulted(1)		
(dollars in thousands)	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
<b>December 31, 2017</b>						
Construction & development	-	\$ -	\$ -	-	\$ -	\$ -
Farmland	2	298	298	-	-	-
Residential	1	48	48	-	-	-
Commercial mortgage	-	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-	-
Consumer & other						
Total	3	<u>\$ 346</u>	<u>\$ 346</u>		\$ -	\$ -

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. No TDRs identified in the last twelve months subsequently defaulted in the year ended December 31, 2017.

<sup>(1)</sup> Loans past due 30 days or more are considered to be in default.

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

### **Purchased Credit Impaired Loans**

There were no purchased credit impaired loans as of December 31, 2017. During 2018, the Company acquired loans as a result of the Great State merger, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans at December 31, 2018 was a follows:

(dollars in thousands)	201	18
Residential	\$	167
Commercial mortgage		347
Commercial & agricultural		200
Outstanding balance	<u>\$</u>	714
Carrying amount	\$	714

There was no accretable yield on purchased credit impaired loans for the period presented.

Purchased credit impaired loans acquired during the year ended December 31, 2018 for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

(dollars in thousands)	2018
Contractually required payments receivable of loans purchased during the year:	
Residential	\$ 233
Commercial mortgage	1,724
Commercial & agricultural	221
	<u>\$ 2,178</u>
Cash flows expected to be collected at acquisition	<u>\$ 1,781</u>
Fair value of acquired loans at acquisition	<u>\$ 1,781</u>

Income is not recognized on purchased credit impaired loans if the Company cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such loans are as follows:

(dollars in thousands)	2018
Loans at beginning of year Loans purchased during the year	<u>\$</u> \$ 1.781
Loans at December 31, 2018	\$ 714

### Note 7. Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2018 and 2017, are as follows:

(dollars in thousands)		2018	2017		
Land	\$	4,935 \$	4,267		
Buildings and improvements		17,493	14,950		
Furniture and equipment		11,228	10,213		
		33,656	29,430		
Less accumulated depreciation		(12,971)	(11,784)		
	<u>\$</u>	20,685 \$	17,646		

Depreciation expense for the years ended December 31, 2018 and 2017 amounted to \$1.2 million and \$1.3 million, 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 \$17.4 million, and \$17.3 million at December 31, 2018 and 2017, respectively.

## Note 9. Goodwill and Intangible Assets

### Goodwill

The change in goodwill during the year ended December 31, 2018 is as follows:

(dollars in thousands)	 2018
Beginning of year	\$ -
Acquired goodwill as result of Great State merger	3,198
Impairment	 
End of the period	\$ 3,198

#### Intangible Assets

The following table presents the activity for the Company's core deposit intangible assets, which are the only identifiable intangible assets subject to amortization. Core deposit intangibles at December 31, 2018 and 2017 are as follows:

(dollars in thousands)		2018	 2017
Balance at beginning of year, net	\$	2,045	\$ 2,327
Core deposit intangible as result of Great State merger		2,425	<b>-</b> .
Amortization expense		(578)	 (282)
Net book value	<u>\$</u>	3,892	\$ 2,045

## Note 10. Deposits

The aggregate amount of time deposits in denominations of more than \$250 thousand at December 31, 2018 and 2017 was \$30.6 million, and \$13.5 million, respectively. At December 31, 2018, the scheduled maturities of all time deposits are as follows:

### (dollars in thousands)

2019	\$ 74,363
2020	37,302
2021	32,538
2022	19,946
2023	15,180
After Five Years	 814
Total	\$ 180,143

#### Note 11. Short-Term Debt

At December 31, 2018 and 2017 the Bank had no debt outstanding classified as short-term.

At December 31, 2018, the Bank had established unsecured lines of credit of approximately \$38.6 million with correspondent banks to provide additional liquidity if, and as needed. In addition, the Bank has the ability to borrow up to approximately \$169.8 million from the Federal Home Loan Bank, subject to the pledging of collateral.

### Note 12. Long-Term Debt

At December 31, 2018 and 2017 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, 2018 and December 31, 2017. 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.

For loans, the carrying amount is net of unearned income and the allowance for loan losses. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

					Fair Value Measurements						
(dollars in thousands)	Carrying Amount		Fair Value		Ā	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
<u>December 31, 2018</u>											
Financial Instruments – Assets Net Loans	\$	532,970	\$	529,155	\$	-	- \$	528,784	\$	371	
Financial Instruments – Liabilities Time Deposits		180,143		176,188		-		176,188		-	
<u>December 31, 2017</u>											
Financial Instruments – Assets Net Loans	\$	421,418	\$	417,229	\$	-	- \$	416,426	\$	803	
Financial Instruments – Liabilities Time Deposits		147,725		144,656		-	-	144,656		-	

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, 2018, 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, 2018 or 2017.

### 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
<u>December 31, 2018</u>					
Investment securities available for sale					
U.S. Government Agencies	\$	245	\$ -	\$ 245	\$ -
Mortgage-backed securities		24,763	-	24,763	-
Corporate securities		2,789	-	2,789	-
State and municipal securities		17,631	 	 17,631	<u> </u>
Total assets at fair value	<u>\$</u>	45,428	\$ 	\$ 45,428	\$ 
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	<u> </u>
Total assets at fair value	\$	50,675	\$ 	\$ 50,675	\$ 

No liabilities were recorded at fair value on a recurring basis as of December 31, 2018 or 2017. There were no significant transfers between levels during the years ended December 31, 2018 or 2017.

### 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, 2018 or 2017. 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	
<u>December 31, 2018</u>		2-1	•					2-1	
Impaired loans	\$	371	\$		- \$		- \$	371	
Foreclosed assets		753					<u> </u>	753	
Total assets at fair value	\$	1.124	\$		- \$		- \$	1,124	

### Note 13. Financial Instruments, continued

Assets Recorded at Fair Value on a Nonrecurring Basis, continued

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

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of December 31, 2018 and 2017, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at December 31, 2018	_	Fair Value at December 31, 2017	Valuation Technique	Significant Unobservable Inputs	General Range of Significant Unobservable Input Values
Impaired Loans	\$ 371	\$	803	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	\$ 753	\$	-	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)		2018	2017
Change in benefit obligation			
Benefit obligation at beginning of year	\$	5,223 \$	4,783
Interest cost		173	191
Actuarial (gain) loss		(824)	637
Benefits paid		(79)	(380)
Settlement (gain) loss			(8)
Benefit obligation at end of year		4,493	5,223
Change in plan assets			
Fair value of plan assets at beginning of year		8,513	7,894
Actual return on plan assets		(342)	999
Benefits paid		(79)	(380)
Fair value of plan assets at end of year		8,092	8,513
Funded status at the end of the year	<u>\$</u>	3,599 \$	3,290

Note 14. Employee Benefit Plans, continued

Grayson Plan	n, continued
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(dollars in thousands)		2018	 2017
Amounts recognized in the Balance Sheet			
Plan benefit cost	\$	4,912	\$ 4,539
Unrecognized net actuarial loss		(1,313)	 (1,249)
Amount recognized in other assets	\$	3,599	\$ 3,290
Amounts recognized in accumulated comprehensive income (loss)			
Unrecognized net actuarial loss	\$	(1,313)	\$ (1,249)
Deferred taxes		275	 262
Amount recognized in accumulated comprehensive income (loss), net	\$	(1,038)	\$ (987)
Prepaid benefit detail			
Benefit obligation	\$	(4,493)	\$ (5,223)
Fair value of assets		8,092	8,513
Unrecognized net actuarial loss		1,313	1,249
Prepaid benefit cost		4,912	 4,539
Components of net periodic pension cost			
Interest cost	\$	173	\$ 191
Expected return on plan assets		(576)	(552)
Recognized net loss due to settlement		-	86
Recognized net actuarial loss		30	 28
Net periodic benefit expense		(373)	 (247)
Additional disclosure information			
Accumulated benefit obligation	\$	4,493	\$ 5,223
Vested benefit obligation	\$ \$	4,493	\$ 5,223
Discount rate used for net periodic pension cost		3.50%	4.00%
Discount rate used for disclosure		4.25%	3.50%
Expected return on plan assets		7.00%	7.00%
Rate of compensation increase		N/A	N/A
Average remaining service (years)		12	13

Using the same fair value hierarchy described in Note 13, 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, 2018  Cash equivalents and short term investments  Mutual funds – equities  Mutual funds – fixed income  Total assets at fair value	\$ - 3,848 4,244 \$ 8,092	3,848 4,244	· -	\$ - - - - -
December 31, 2017  Cash equivalents and short term investments  Mutual funds – equities  Mutual funds – fixed income  Total assets at fair value	\$ 4,368 4,145 \$ 8,513	\$ 4,368 4,145 \$ 8,513	\$ - - - <u>\$</u> -	\$ - - - <u>\$</u> -

### Note 14. Employee Benefit Plans, continued

Grayson Plan, continued

**Estimated Future Benefit Payments** 

(dollars in thousands)	Pensi Bene	
2019	\$	439
2020		15
2021		250
2022		210
2023		1,091
2024 - 2028		1,407
	\$	3.412

### **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, 2018 and there is no required contribution for 2019. Based on this we do not anticipate making a contribution to the plan in 2019.

### 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, 2018 and 2017, by asset category are as follows:

	2018	2017
Mutual funds – fixed income	52%	49%
Mutual funds – equity	48%	51%
Cash and equivalents	0%	0%
Total	<u> 100%</u>	100%

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.

### Note 14. Employee Benefit Plans, continued

### Grayson Plan, continued

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,

	2018 Valuation	2017 Valuation		
<u>Source</u>	<b>Report</b>	<b>Report</b>		
Bank of Floyd Plan	106.44%	108.63%		

#### **Employer Contributions**

Plan expenses paid by the Company totaled approximately \$54 thousand and \$58 thousand for the years ended December 31, 2018 and 2017, 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 \$258 thousand and \$312 thousand at December 31, 2018 and 2017, respectively. Expense charged against income and included in salary and benefits expense was \$23 thousand and \$27 thousand in 2018 and 2017, 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. The liability accrued for this obligation was \$143 thousand and \$36 thousand at December 31, 2018 and 2017, respectively. Expense charged against income and included in salary and benefits expense was \$107 thousand and \$36 thousand in 2018 and 2017, respectively, for these supplemental executive retirement plans.

Prior to the Cardinal 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 \$768 thousand and \$805 thousand at December 31, 2018 and 2017, respectively. Charges to income amounted to approximately \$32 thousand for 2018 and 2017. 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)		2018		2017	
Current	\$	(375)	\$	213	
Deferred		1,589		2,891	
	\$	1,214	\$	3,104	

#### 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)	 2018	2017	
Tax at statutory federal rate	\$ 1,205 \$	1,881	
Tax exempt interest income	(49)	(61)	
Tax exempt insurance income	(155)	(151)	
State income tax, net of federal benefit	21	9	
Merger expenses	162	4	
Other	30	(13)	
Deferred tax asset re-measurement	 <u> </u>	1,435	
	\$ 1,214 \$	3,104	

### **Deferred Income Tax Analysis**

The significant components of net deferred tax assets (all Federal) at December 31, 2018 and 2017 are summarized as follows:

(dollars in thousands)	 2018	 2017
Deferred tax assets		
Allowance for loan losses	\$ 603	\$ 482
Acquired loan credit mark	1,061	842
Deferred compensation	322	335
Investment impairment charge recorded directly to stockholders'		
equity as a component of other comprehensive income	57	19
Minimum pension liability	276	262
Net operating loss carryforward	1,738	2,131
Alternative minimum tax credit carryforward	294	638
Net unrealized losses on securities available for sale	247	139
Nonaccrual interest income	206	217
Purchase accounting adjustments	144	-
Other	 216	 76
	\$ 5,164	\$ 5,141
Deferred tax liabilities		
Deferred loan origination costs	635	228
Core deposit intangible	831	433
Accrued pension costs	1,049	962
Depreciation	795	553
Accretion of discount on investment securities, net	 1	 <u> </u>
	\$ 3,311	\$ 2,176
Net deferred tax asset	\$ 1,853	\$ 2,965

#### 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 remeasurement 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 2015 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, 2018 and 2017. The net operating loss of approximately \$8.3 million, if not utilized 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 onbalance sheet instruments. A summary of the Bank's commitments at December 31, 2018 and 2017 is as follows:

(dollars in thousands)	 2018	 2017
Commitments to extend credit	\$ 76,977	\$ 56,912 1,106
Standby letters of credit	\$ 78,204	\$ 58,018

### 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. 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 2018 and 2017 loan transactions with related parties were as follows:

(dollars in thousands)	2	018	2017	
Balance, beginning	\$	4,769 \$	5,112	
New loans		2,662	1,388	
Repayments		(2,502)	(1,228)	
Change in relationship		2,620	(503)	
Balance, ending	<u>\$</u>	7,549 \$	4,769	

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 \$8.2 million, and \$10.7 million at December 31, 2018 and 2017, respectively.

## **Note 19. 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 \$7.6 million at December 31, 2018. No 23A transactions were deemed to exist between the Company and the Bank at December 31, 2018.

### Capital Requirements

The Bank is 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 minimum capital ratios: (i) a 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; (iii) a total capital ratio of 8% of risk-weighted assets; and (iv) a leverage ratio of 4% of total assets. As fully phased in on January 1, 2019, the rules require 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, 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, 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, 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 has been 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.

### Note 19. Regulatory Restrictions, continued

#### Capital Requirements, continued

The rules also revised the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following capital level requirements in order to qualify as "well capitalized:" a common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8%; a total capital ratio of 10%; and a Tier 1 leverage ratio of 5%.

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, and is not obligated to report consolidated regulatory capital. The Bank's actual capital amounts and ratios are presented in the following table as of December 31, 2018 and 2017. These ratios comply with Federal Reserve rules to align with the Basel III Capital requirements effective January 1, 2015.

					For Ca	pital		To Be V	Well-		
		Actu	ıal	Α	dequacy	_		Capitalized			
	A	mount	Ratio	Α	mount	Ratio	A	mount	Ratio		
December 31, 2018											
Total Capital											
(to risk weighted assets)	\$	71,424	13.00%	\$	43,943	8.00%	\$	54,929	10.00%		
Tier 1 Capital											
(to risk weighted assets)	\$	67,899	12.36%	\$	32,958	6.00%	\$	43,943	8.00%		
Common Equity Tier 1											
(to risk weighted assets)	\$	67,899	12.36%	\$	24,718	4.50%	\$	35,704	6.50%		
Tier 1 Capital											
(to average total assets)	\$	67,899	10.08%	\$	26,932	4.00%	\$	33,664	5.00%		
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%		

As directed by the Economic Growth Act, on November 21, 2018, the federal banking regulators jointly issued a proposed rule that would permit qualifying banks that have less than \$10 billion in total consolidated assets to elect to be subject to a 9% "community bank leverage ratio." A qualifying bank that has chosen the proposed framework would not be required to calculate the existing risk-based and leverage capital requirements and would be considered to have met the capital ratio requirements to be "well capitalized" under prompt corrective action rules, provided it has a community bank leverage ratio greater than 9%. This proposed rule has not been finalized and, as a result, the content and scope of any final rule, and its impact on the Bank (if any), cannot be determined at this time.

## Note 20. Parent Company Financial Information

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

# Balance Sheets December 31, 2018 and 2017

(dollars in thousands)		2018	2017
Assets			
Cash and due from banks	\$	1,409 \$	1,518
Investment in affiliate bank		73,813	55,115
Other assets		468	586
Total assets	<u>\$</u>	75,690 \$	57,219
Liabilities			
Other liabilities	<u>\$</u>	68 \$	37
Stockholders' Equity			
Common stock		-	-
Surplus		41,660	26,166
Retained earnings		35,929	32,526
Accumulated other comprehensive loss		(1,967)	(1,510)
Total stockholders' equity		75,622	57,182
Total liabilities and stockholders' equity	<u>\$</u>	75,690 \$	57,219

## Statements of Income For the years ended December 31, 2018 and 2017

(dollars in thousands)	20	018	2017
Income			
Dividends from affiliate bank	\$	1,123 \$	803
Bargain purchase gain		-	-
Other income		1	1
		1,124	804
Expenses			
Management and professional fees		39	35
Other expenses		37	36
		76	71
Income before tax benefit and equity			
in undistributed income of affiliate		1,048	733
Federal income tax expense		16	(161)
Income before equity in undistributed			
income of affiliate		1,064	572
Equity in undistributed income of affiliate		3,462	1,855
Net income	\$	4,526 \$	2,427

### Note 20. Parent Company Financial Information, continued

# Statements of Cash Flows For the years ended December 31, 2018 and 2017

(dollars in thousands)	 2018	2017
Cash flows from operating activities		
Net income	\$ 4,526 \$	2,427
Adjustments to reconcile net income		
to net cash provided by operations:		
Equity in undistributed income of affiliate	(3,462)	(1,855)
Change in other assets	(80)	91
Change in other liabilities	 31	37
Net cash provided by operating activities	 1,015	700
Cash flows from investing activities		
Net decrease in loans	-	-
Cash received in business combination	 <u> </u>	<u> </u>
Net cash provided by investing activities	 <u>-</u>	<u>-</u>
Cash flows from financing activities		
Cash paid for fractional shares	(1)	-
Dividends paid	 (1,123)	(803)
Net cash used by financing activities	 (1,124)	(803)
Net decrease in cash and cash equivalents	(109)	(103)
Cash and cash equivalents, beginning	1,518	1,621
Cash and cash equivalents, ending	\$ 1,409 \$	1,518
Business combinations		
Elimination of Company's existing investment in Great State Bank	\$ <u> 198</u> \$	<u> </u>
Stock issued to acquire Great State Bank	\$ 15,495 \$	

#### **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.

In January 2019, the Board of Directors of the Company approved a stock repurchase plan. The Board of Directors has authorized an initial repurchase of up to 200,000 shares of its common stock from time to time for a period of two years ending in January 2021.

The Company intends to purchase shares periodically through privately negotiated transactions or in the open market in accordance with Securities and Exchange Commission rules. The actual timing, number and value of shares repurchased under the plan will be determined by management in its discretion and will depend on a number of factors, including the market price of the shares, general market and economic conditions, applicable legal requirements and other conditions.

## **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" or the "Company") was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell company 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 pursuant to which Grayson and Cardinal merged with and into Parkway, with Parkway as the surviving corporation (the "Cardinal 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 Cardinal merger was completed on July 1, 2016. Grayson was considered the acquiror and Cardinal was 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. Effective March 13, 2017, the Bank changed its name to Skyline National Bank.

On March 1, 2018, Parkway entered into a definitive agreement pursuant to which Parkway acquired Great State Bank ("Great State"), based in Wilkesboro, North Carolina. The agreement provided for the merger of Great State with and into the Bank, with the Bank as the surviving bank (the "Great State merger"). The transaction closed and the merger became effective on July 1, 2018. Each share of Great State common stock was converted into the right to receive 1.21 shares of Parkway common stock. The Company issued 1,191,899 shares and recognized \$15.5 million in surplus in the Great State merger. Parkway was considered the acquiror and Great State was considered the acquiree in the transaction for accounting purposes. Pursuant to the Great State merger, the Company acquired \$145.5 million of assets, including \$95.1 million in loans and assumed \$133.0 million in liabilities, including \$130.6 million of deposits, on July 1, 2018. Such amounts include preliminary estimated fair value adjustments, which are subject to change.

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 North Carolina counties of Alleghany, Ashe, Burke, Caldwell, Catawba, Cleveland, Watauga, Wilkes, and Yadkin, and the surrounding areas through twenty full-service banking offices and four loan production offices. As an FDIC-insured national banking association, the Bank is subject to regulation by the Comptroller of the Currency and the FDIC. Parkway is regulated by the Board of Governors of the Federal Reserve System.

For purposes of this annual report, 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. All information contained herein as of and for periods prior to July 1, 2018 reflects the operations of Parkway prior to the Great State 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, 2018 refer to the combined company and its subsidiary as a combined entity after the Great State merger, and all references to "Parkway" or the "Company" as of and for periods prior to July 1, 2018 are references to Parkway and its subsidiary as a combined entity prior to the merger.

Parkway had net earnings of \$4.5 million for 2018 compared to \$2.4 million for 2017. Earnings in 2018 and 2017 were impacted significantly by the acquisition of Great State, including merger-related expenses during 2018 and the inclusion of Great State's financial results beginning July 1, 2018. Interest income and interest expense increased due to the acquired loans and deposits, in addition to increases in interest rates earned on loans and paid on deposits. Non-recurring merger related expenses totaled approximately \$2.0 million in 2018 and \$748 thousand in 2017. 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.

### **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;
- disruptions to customer and employee relationships and business operations caused by the Great State merger or otherwise;
- 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, 2018 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 techniques 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)

		2018			2017			2016	
	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	\$ 9,365	\$ 106	1.13%	\$ 9,611	\$ 48	0.50%	\$ 9,977	\$ 37	0.37%
Federal funds sold	10,584	228	2.15%	9,703	111	1.14%	9,316	46	0.49%
Investment securities	50,504	1,278	2.53%	59,210	1,393	2.35%	51,027	1,195	2.34%
Loans 1, 2	476,900	24,574	5.15%	417,723	20,722	4.96%	325,723	16,284	5.00%
Total	547,353	26,186		496,247	22,274		396,043	17,562	
Yield on average									
interest-earning assets			4.78%			4.49%			4.43%
Non interest-earning assets:									
Cash and due from banks	8,218			7,145			10,256		
Premises and equipment	19,055			17,852			14,603		
Interest receivable and other	35,400			33,449			22,279		
Allowance for loan losses	(3,435)			(3,539)			(3,927)		
Unrealized gain/(loss) on securities	(1,283)			(356)			364		
Total	57,955			54,551			43,575		
Total assets	\$605,308			\$550,798			\$439,618		
1 otal assets	\$005,508			\$550,778			\$437,018		
Interest-bearing liabilities:									
Demand deposits	\$115,409	194	0.17%	\$ 59,485	52	0.09%	\$ 42,848	44	0.10%
Savings deposits	117,479	347	0.30%	143,895	342	0.24%	107,546	247	0.23%
Time deposits	163,932	1,326	0.81%	159,733	1,079	0.68%	132,637	995	0.75%
Borrowings	1,757	34	1.94%	37	1_	1.93%	11,412	442	3.87%
Total	398,577	1,901		363,150	1,474		294,443	1,728	
Cost on average									
interest-bearing liabilities			0.48%			0.41%			0.59%
Non interest-bearing									
liabilities:									
Demand deposits	139,409			128,356			100,425		
Interest payable and other	2,826			2,351			1,729		
Total	142,235			130,707			102,154		
Total liabilities	540,812			493,857			396,597		
Stockholder's equity:	64,496			56,941			43,021		
Total liabilities and									
stockholder's equity	\$605,308			\$550,798			\$439,618		
Net interest income		\$24,285			\$20,800			\$ 15,834	
Net yield on									
interest-earning assets			4.44%			4.19%			3.99%

<sup>1</sup> Includes nonaccural loans

<sup>&</sup>lt;sup>2</sup> Interest income includes loan fees

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

	20	18 Co	mpared to	2017	<b>2017 Compared to 2016</b>							
	Interest Income Expense			iance able To <sup>(1)</sup>	Interest Income/ Expense		iance cable To <sup>(1)</sup>					
	<u>Variano</u>	<u>e</u> _	Rate	Volume	<u>Variance</u>	Rate	Volume					
Interest-earning assets:												
Interest bearing deposits	\$	58 \$	59	\$ (1)	\$ 11	\$ 12	\$ (1)					
Federal funds sold	]	17	106	11	65	63	2					
Investment securities	(1	15)	121	(236)	198	5	193					
Loans	3,8	<u>52</u>	827	3,025	4,438	(131)	4,569					
Total	3,9	12	1,113	2,799	4,712	(51)	4,763					
Interest-bearing liabilities:												
Demand deposits	]	42	70	72	8	(4)	12					
Savings deposits		5	21	(16)	95	11	84					
Time deposits	2	47	218	29	84	(100)	184					
Borrowings		33	<u>=</u>	33	(441)	(1)	(440)					
Total		27	309	118	(254)	(94)	(160)					
Net interest income	\$ 3,4	85 \$	804	<u>\$ 2,681</u>	\$ 4,966	<u>\$ 43</u>	<u>\$ 4,923</u>					

<sup>(1)</sup> 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, 2018, total interest income increased by \$3.9 million compared to the year ended December 31, 2017. As noted above, the Great State merger was completed on July 1, 2018; therefore, the operating results for 2018 include six months of combined earnings along with six months of Parkway earnings prior to the merger. As a result, the increase in interest income on loans for the year ended December 31, 2018 was due to increased volume resulting from the merger, along with increases in rates on loans. 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 \$394 thousand due to the addition of interest-bearing deposits from the Great State merger, along with increases in the rates paid on deposits. Amortization of premiums on acquired time deposits, which reduces interest expense, totaled \$327 thousand for the year ended December 31, 2018, compared to \$228 thousand for the year ended December 31, 2017. Interest on borrowings increased by \$33 thousand due to overnight borrowings which were accessed in the second and third quarters of 2018 along with FHLB Advances that were acquired as part of the Great State merger. The effects of changes in volumes and rates on net interest income in 2018 compared to 2017, and 2017 compared to 2016 are shown in Table 2.

The aforementioned factors led to an increase in net interest income of \$3.5 million or 16.75% for 2018 as compared to 2017. The net yield on interest-earning assets increased by 25 basis points to 4.44% in 2018 compared to 4.19% in 2017.

#### **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 \$325 thousand for the year ended December 31, 2018, compared to \$217 thousand for the year ended December 31, 2017. Asset quality has remained relatively consistent over the past year; therefore, the increase in loan loss provisions from 2017 to 2018 was due primarily to overall growth in the loan portfolio. The reserve for loan losses at December 31, 2018 was approximately 0.65% of total loans, compared to 0.81% at December 31, 2017. Management's estimate of probable credit losses inherent in the acquired Great State loan portfolio was reflected as a purchase discount which will continue to be accreted into income over the remaining life of the acquired loans in addition to the previously acquired loan portfolio from the merger with Cardinal Bankshares Corporation. As of December 31, 2018, the remaining unaccreted discount on the acquired loan portfolios totaled \$5.0 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 increased by \$409 thousand in 2018 compared to 2017. The increase was due to service-related income from the Company's increased customer base following the merger with Great State as well as nonrecurring proceeds from life insurance contracts totaling \$303 thousand in 2018. Securities gains decreased by \$237 thousand for the year ended December 31, 2018 compared to the same period last year as increases in interest rates led to decreases in the market value of the Bank's investment securities portfolio. 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 in connection with the Cardinal merger. 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.

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

	 2018	2017		2016
Service charges on deposit accounts	\$ 1,538	\$ 1,32	6 \$	1,256
Increase in cash value of life insurance	433	44	4	382
Life insurance income	303		-	-
Mortgage originations fees	396	29	3	167
Safe deposit box rental	93	9	4	78
Gain on securities	5	24	2	364
ATM income	1,324	96	7	750
Investment services income	126	8	4	133
Merchant services income	171	14	.7	144
Bargain purchase gain	-		_	891
Interchange income	126	30	5	206
Other income	 122	32	.6	199
Total noninterest income	\$ 4,637	\$ 4,22	8 \$	4,570

### Other Expense

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

Total noninterest expenses increased by \$3.6 million, or 18.55% for the year ended December 31, 2018, compared to the year ended December 31, 2017. As noted above, the overall increase in expenses for the comparative periods was due primarily to the Great State merger, as the 2018 expenses reflect six months of combined operations. Accordingly, salaries and employee benefits increased by \$1.5 million due to the increase in the number of employees, and occupancy expenses increased by \$177 thousand due to the addition of six banking facilities. Data processing expense increased by \$176 thousand due to the increased accounts and transaction volume. Nonrecurring merger related expenses totaled \$2.0 million in 2018, compared to \$748 thousand in 2017. The increase in noninterest expense in 2017, compared to 2016, was also due primarily to the Cardinal merger.

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

		2018	2017		2016
Salaries & wages	\$	9,034	\$ 8,23	0 \$	6,772
Employee benefits		2,768	2,05	3	1,858
Total personnel expense		11,802	10,28	3	8,630
Director fees		370	32	7	257
Occupancy expense		1,260	1,08	3	815
Data processing expense		1,353	1,17	7	888
Other equipment expense		988	1,11	7	1,170
FDIC/OCC assessments		390	42	6	350
Insurance		121	12	9	127
Professional fees		452	43	0	327
Advertising		569	61	2	208
Postage & freight		362	31	1	235
Supplies		212	27	7	159
Franchise tax		438	39	7	270
Telephone		415	37	0	279
Travel, dues & meetings		490	41	4	299
ATM expense		423	38	8	355
Foreclosure expenses		32	4	4	79
Core deposit intangible amortization		578	28	2	142
Merger related expenses		1,978	74	8	1,483
Other expense		624	46	<u>5</u>	743
Total noninterest expense	<u>\$</u>	22,857	\$ 19,28	0 \$	16,816

The overhead efficiency ratio of noninterest expense to adjusted total revenue (net interest income plus noninterest income) was 79.03% in 2018, 77.03% in 2017, and 82.42% in 2016. The ratios for 2018 and 2017, without the effect of nonrecurring merger related costs, would have been 72.19% and 74.05%, 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 \$1.2 million in 2018 and \$3.1 million in 2017, resulting in effective tax rates of 21.1% and 56.1%, respectively. The decrease in 2018 along with 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 \$1.9 million, and \$3.0 million existed at December 31, 2018 and 2017 respectively. At December 31, 2018, net deferred tax assets included \$247 thousand of deferred tax assets applicable to unrealized losses on investment securities available for sale, and \$276 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 10.30% from 2017 to 2018 due primarily to the Great State merger. Total earning assets represented 90.43% of total average assets in 2018 and 90.09% in 2017. The mix of average earning assets changed from 2017 to 2018 as average loans increased by \$59.2 million, or 14.17% and average investment securities decreased by \$8.7 million, or 14.70%.

Table 5. Average Asset Mix (dollars in thousands)

	201	18	2017						
	Average Balance	%	 Average Balance	%					
Earning assets:									
Loans	\$ 476,900	78.79%	\$ 417,723	75.84%					
Investment securities	50,504	8.34%	59,210	10.75%					
Federal funds sold	10,584	1.75%	9,703	1.76%					
Deposits in other banks	9,365	1.55%	 9,611	1.74%					
Total earning assets	 547,353	90.43%	 496,247	90.09%					
Non earning assets:									
Cash and due from banks	8,218	1.36%	7,145	1.30%					
Premises and equipment	19,055	3.14%	17,852	3.24%					
Other assets	35,400	5.85%	33,449	6.07%					
Allowance for loan losses	(3,435)	-0.57%	(3,539)	-0.64%					
Unrealized gain (loss) on securities	(1,283)	-0.21%	(356)	-0.06%					
Total nonearning assets	57,955	9.57%	54,551	9.91%					
Total assets	\$ 605,308	100.00%	\$ 550,798	100.00%					

Average loans for 2018 represented 78.79% of total average assets compared to 75.84% in 2017. Average federal funds sold decreased from 1.76% to 1.75% of total average assets while average investment securities decreased from 10.75% to 8.34% of total average assets over the same time period. The balances of nonearning assets to total average assets decreased from 9.91% to 9.57%.

#### Loans

Average loans totaled \$476.9 million over the year ended December 31, 2018. This represents an increase of 14.17% from the average of \$417.7 million for 2017. The increase was due primarily to loans acquired from the Great State merger. Average loans increased by 28.24% from 2016 to 2017.

The loan portfolio consists primarily of real estate and commercial loans. These loans accounted for 95.35% of the total loan portfolio at December 31, 2018. This is down slightly from the 95.67% that the two categories maintained at December 31, 2017. 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, 2018 are presented in Tables 6 and 7, respectively.

**Table 6. Loan Portfolio Summary (dollars in thousands)** 

	December	31, 2018	December	31, 2017	December			
	Amount	%	Amount	%	Amount	%		
Construction and development	\$ 33,449	6.23%	\$ 25,475	6.00%	\$ 26,464	6.42%		
Residential, 1-4 families	199,662	37.22%	170,080	40.03%	160,502	38.96%		
Residential, 5 or more families	36,027	6.72%	29,040	6.84%	26,686	6.48%		
Farm land	33,291	6.21%	33,353	7.85%	33,531	8.14%		
Nonfarm, nonresidential	176,192	32.84%	125,661	29.57%	128,515	31.20%		
Total real estate	478,621	89.22%	383,609	90.29%	375,698	91.20%		
Agricultural	4,600	0.86%	2,792	0.66%	2,779	0.67%		
Commercial	32,891	6.13%	22,880	5.38%	23,307	5.66%		
Consumer	7,396	1.38%	5,868	1.38%	5,491	1.33%		
Other	12,957	2.41%	9,722	2.29%	4,693	1.14%		
Total	<u>\$ 536,465</u>	<u>100.00%</u>	<u>\$ 424,871</u>	100.00%	<u>\$ 411,968</u>	<u>100.00%</u>		
			December	31, 2015	December	31, 2014		
			December Amount	31, 2015	December Amount	31, 2014 %		
Construction and development			Amount	%	Amount	%		
Construction and development			<b>Amount</b> \$ 14,493	6.01%	<b>Amount</b> \$ 17,158	<b>%</b> 7.70%		
Residential, 1-4 families			* 14,493 112,781	6.01% 46.76%	* 17,158 110,519	7.70% 49.56%		
Residential, 1-4 families Residential, 5 or more families			* 14,493 112,781 12,203	6.01% 46.76% 5.06%	* 17,158 110,519 8,606	7.70% 49.56% 3.86%		
Residential, 1-4 families Residential, 5 or more families Farm land			**Mount \$ 14,493	6.01% 46.76% 5.06% 13.06%	\$ 17,158 110,519 8,606 28,570	7.70% 49.56% 3.86% 12.81%		
Residential, 1-4 families Residential, 5 or more families			* 14,493 112,781 12,203	6.01% 46.76% 5.06%	* 17,158 110,519 8,606	7.70% 49.56% 3.86%		
Residential, 1-4 families Residential, 5 or more families Farm land Nonfarm, nonresidential Total real estate			\$ 14,493 112,781 12,203 31,512 52,463 223,452	6.01% 46.76% 5.06% 13.06% 21.75% 92.64%	\$ 17,158 110,519 8,606 28,570 43,046 207,899	7.70% 49.56% 3.86% 12.81% 19.30% 93.23%		
Residential, 1-4 families Residential, 5 or more families Farm land Nonfarm, nonresidential Total real estate  Agricultural			\$ 14,493 112,781 12,203 31,512 52,463 223,452 1,383	6.01% 46.76% 5.06% 13.06% 21.75% 92.64%	\$ 17,158 110,519 8,606 28,570 43,046 207,899	7.70% 49.56% 3.86% 12.81% 19.30% 93.23%		
Residential, 1-4 families Residential, 5 or more families Farm land Nonfarm, nonresidential Total real estate  Agricultural Commercial			\$ 14,493 112,781 12,203 31,512 52,463 223,452 1,383 11,399	6.01% 46.76% 5.06% 13.06% 21.75% 92.64% 0.57% 4.73%	\$ 17,158 110,519 8,606 28,570 43,046 207,899 1,338 8,954	7.70% 49.56% 3.86% 12.81% 19.30% 93.23% 0.60% 4.02%		
Residential, 1-4 families Residential, 5 or more families Farm land Nonfarm, nonresidential Total real estate  Agricultural Commercial Consumer			\$ 14,493 112,781 12,203 31,512 52,463 223,452 1,383 11,399 3,962	6.01% 46.76% 5.06% 13.06% 21.75% 92.64% 0.57% 4.73% 1.64%	\$ 17,158 110,519 8,606 28,570 43,046 207,899 1,338 8,954 3,816	7.70% 49.56% 3.86% 12.81% 19.30% 93.23% 0.60% 4.02% 1.71%		
Residential, 1-4 families Residential, 5 or more families Farm land Nonfarm, nonresidential Total real estate  Agricultural Commercial			\$ 14,493 112,781 12,203 31,512 52,463 223,452 1,383 11,399	6.01% 46.76% 5.06% 13.06% 21.75% 92.64% 0.57% 4.73%	\$ 17,158 110,519 8,606 28,570 43,046 207,899 1,338 8,954 3,816 984	7.70% 49.56% 3.86% 12.81% 19.30% 93.23% 0.60% 4.02%		

Table 7. Maturity Schedule of Loans, as of December 31, 2018 (dollars in thousands)

		Real		Agricultural		Consumer		Total			
	<b>Estate</b>			& Commercial	_	& Other	_	Amount	%		
Fixed rate loans:											
Three months or less	\$	4,375	\$	1,554	\$	4,273	\$	10,202	1.90%		
Over three to twelve months		12,579		4,014		1,738		18,331	3.42%		
Over one to five years		116,157		15,115		5,854		137,126	25.56%		
Over five years		38,510		2,501		6,427		47,438	8.84%		
Total fixed rate loans	\$	171,621	\$	23,184	\$	18,292	\$	213,097	39.72%		
Variable rate loans:											
Three months or less	\$	6,486	\$	2,057	\$	151	\$	8,694	1.62%		
Over three to twelve months		8,403		6,004		71		14,478	2.70%		
Over one to five years		7,397		1,902		88		9,387	1.75%		
Over five years		284,714		4,344		1,751		290,809	54.21%		
Total variable rate loans	\$	307,000	\$	14,307	\$	1,751	\$	290,809	60.28%		
Total loans:											
Three months or less	\$	10,861	\$	3,611	\$	4,424	\$	18,896	3.52%		
Over three to twelve months		20,982		10,018		1,809		32,809	6.12%		
Over one to five years		123,554		17,017		5,942		146,513	27.31%		
Over five years		323,224		6,845		8,178		338,247	63.05%		
Total loans	\$	478,621	\$	37,491	\$	20,353	\$	536,465	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 5.15% in 2018 compared to an average yield of 4.96% in 2017. The increase in loan yields was due primarily to the Great State merger, along with repricing of loans at higher rates.

#### **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 2018 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 \$4.7 million from December 31, 2017 to December 31, 2018, while the average balance of investment securities carried throughout the year decreased by approximately \$8.7 million from 2017 to 2018. 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 2.53% for the year ended December 31, 2018 compared to 2.35% for 2017.

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

					D	ecember	31	1, 2018								
		In One Year or Less		Through		After Five Through Ten Years		After Ten Years		Book Value 12/31/18		Iarket Value 2/31/18	Book Value 12/31/17		Book Value 12/31/16	
Investment securities:			•		•											
U.S. Government agencies	\$	-	\$	244	\$	- 3	\$	-	\$	244	\$	245	\$	-	\$	<del>-</del>
Govt. sponsored enterprises		-				-		-		-		-		-		2,046
Mortgage-backed securities		451		5,427		11,672		8,077		25,627		24,763		28,780		36,021
Corporate securities		-		1,470		1,500		-		2,970		2,789		3,016		3,061
State and municipal securities		252		7,889		2,399		7,224	_	17,764		17,631		19,542		22,282
Total	\$	703	\$	15,030	\$	15,571	\$	15,301	\$	46,605	\$	45,428	\$	51,338	\$	63,410
Weighted average yields:																
U.S. Government agencies		0.00%		2.89%		0.00%		0.00%		2.89%						
Mortgage-backed securities		2.81%		2.21%		2.15%		2.34%		2.23%						
Corporate securities		0.00%		3.00%		3.20%		0.00%		3.10%						
State and municipal securities		2.79%		2.94%		2.94%		2.94%		2.83%						
Total	_	2.81%	_	2.55%	_	2.37%		2.62%	_	2.52%						

#### **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 recent 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.

Average total deposits for the year ended December 31, 2018 amounted to \$536.2 million, which was an increase of \$44.8 million, or 9.11% from 2017. The increase was due primarily to deposits acquired in the Great State merger. Average core deposits totaled \$473.6 million in 2018 representing a 7.98% increase over the \$438.6 million in 2017. The percentage of the Company's average deposits that are interest-bearing has remained consistent in recent years at 73.8% in 2016, 73.9% in 2017, and 74.0% in 2018. Average demand deposits, which earn no interest, increased 8.61% from \$128.4 million in 2017 to \$139.4 million in 2018. Average deposits for the periods ended December 31, 2018, 2017, and 2016 are summarized in Table 9.

**Table 9. Deposit Mix (dollars in thousands)** 

		Dec	cember 31, 20	18	December 31, 2017			
	Average Balance		% of Total Deposits	Average Rate Paid		Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:								
Interest-bearing DDA accounts	\$	66,984	12.5%	0.10%	\$	59,485	12.1%	0.09%
Money market		48,425	9.0%	0.26%		42,711	8.7%	0.21%
Savings		117,479	21.9%	0.30%		101,184	20.6%	0.25%
Individual retirement accounts		45,598	8.5%	0.99%		47,045	9.6%	0.91%
Small denomination certificates		55,700	10.4%	0.57%		59,820	12.2%	0.41%
Large denomination certificates		62,634	11.7%	0.89%		52,868	10.7%	0.76%
Total interest-bearing deposits		396,820	74.0%	0.47%		363,113	73.9%	0.41%
Noninterest-bearing deposits		139,409	26.0%	0.00%		128,356	26.1%	0.00%
Total deposits	\$	536,229	100.0%	0.35%	\$	491,469	100.0%	0.30%

		<b>December 31, 2016</b>				
	A	Average		Average		
	<u>B</u>	alance	<b>Deposits</b>	Rate Paid		
Interest-bearing deposits:	·					
Interest-bearing DDA accounts	\$	42,848	11.2%	0.10%		
Money market		30,482	7.9%	0.21%		
Savings		77,064	20.1%	0.24%		
Individual retirement accounts		41,770	10.9%	1.06%		
Small denomination certificates		49,942	13.0%	0.52%		
Large denomination certificates		40,925	10.7%	0.71%		
Total interest-bearing deposits		283,031	73.8%	0.45%		
Noninterest-bearing deposits		100,425	26.2%	0.00%		
Total deposits	<u>\$</u>	383,456	100.0%	0.33%		

The average balance of certificates of deposit issued in denominations of \$100,000 or more increased by \$9.8 million, or 18.47%, for the year ended December 31, 2018 due to the Great State 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 2018 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, 2018.

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

Analysis of certificates of deposit of \$100,000 or more at l	December 31, 20	18:
Remaining maturity of three months or less	\$	12,260
Remaining maturity over three months through six months		7,322
Remaining maturity over six months through twelve months		19,206
Remaining maturity over twelve months		39,022
Total certificates of deposit of \$100,000 or more	\$	77,810

### **Equity**

Stockholders' equity totaled \$75.6 million at December 31, 2018 compared to \$57.2 million at December 31, 2017. \$15.5 million of the increase is due to the issuance of common stock in connection with the merger with Great State. The remaining increase was due to earnings of \$4.5 million, less a net change in accumulated other comprehensive losses totaling \$457 thousand, and the payment of dividends of \$1.1 million. Book value increased from \$11.39 per share at December 31, 2017 to \$12.17 per share at December 31, 2018. Tangible book value increased from \$10.98 per share at December 31, 2017 to \$11.03 per share at December 31, 2018.

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 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; (iii) a total capital ratio of 8% of risk-weighted assets; and (iv) a leverage ratio of 4% of total assets. As fully phased in on January 1, 2019, the rules require 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, 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, 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, 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)

	2018	2017
Tier 1 Capital	\$ 67,899	\$ 53,483
Unrealized gains on AFS preferred stock	-	·
Qualifying allowance for loan losses		
(limited to 1.25% of risk-weighted assets)	3,525	3,479
Total regulatory capital	<u>\$ 71,424</u>	<u>\$ 56,962</u>
Total risk-weighted assets	<u>\$ 549,292</u>	\$ 433,604
Tier 1 capital as a percentage of		
risk-weighted assets	12.4%	12.3%
Common Equity Tier 1 capital as a percentage of		
risk-weighted assets	12.4%	12.3%
Total regulatory capital as a percentage of		
risk-weighted assets	13.0%	13.1%
Leverage ratio*	10.1%	9.8%

### 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, 2018, 2017, 2016, 2015, and 2014 are analyzed in Table 12.

**Table 12. Nonperforming Assets (dollars in thousands)** 

4,608
10,525
15,133
657
15,790
6.8%
4.7%
_ =

Total nonperforming loans were 2.3% and 3.1% of total outstanding loans as of December 31, 2018 and 2017, respectively. The majority of the increase in nonaccrual loans from 2017 to 2018 came in the "commercial mortgage" category. Nonaccrual loans in this category increased by \$546 thousand. 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, 2018 and 2017, interest income recognized on loans in nonaccrual status was approximately \$58 thousand and \$181 thousand, respectively. Had these credits been current in accordance with their original terms, the gross interest income for these credits would have been approximately \$277 thousand and \$337 thousand, respectively for the years ended December 31, 2018 and 2017.

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 2017 to 2018 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 increase in foreclosed assets from 2017 to 2018 resulted from the transfer of a nonfarm, nonresidential property during the year. Sales and market adjustments of foreclosed assets in 2018 resulted in a net loss of \$10 thousand. More information on nonperforming assets can be found in Note 6 of the "Notes to Consolidated Financial Statements" found in the company's 2018 Annual Report.

As of December 31, 2018 and 2017 we had loans with a current principal balance of \$56.0 million and \$38.2 million rated "Watch" or "Special Mention". The increase was due primarily to the acquisition of loans in the Great State merger, along with 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, 2018 loans past due 30-89 days and still accruing totaled \$863 thousand compared to \$421 thousand at December 31, 2017.

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, 2018 totaled \$6.2 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, 2018 was approximately 0.65% of total loans, compared to 0.81% at December 31, 2017. Management's estimate of probable credit losses inherent in the acquired Great State loan portfolio was reflected as a purchase discount which will continue to be accreted into income over the remaining life of the acquired loans in addition to the previously acquired loan portfolio from the merger with Cardinal Bankshares Corporation. As of December 31, 2018, the remaining unaccreted discount on the acquired loan portfolios totaled \$5.0 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)

		2018	2017	2016	2015	2014
Allowance for loan losses, beginning	\$	3,453 \$	3,420 \$	3,418 \$	4,185 \$	4,591
Provision for (reduction of) loan losses, added		325	217	(5)	(187)	294
Charge-offs:						
Commercial and agricultural		(23)	(27)	(19)	(1)	(78)
Real estate – construction		(20)	(33)	(20)	(186)	(268)
Real estate – mortgage		(259)	(182)	(105)	(469)	(599)
Consumer and other		(175)	(76)	(70)	(30)	(4)
Recoveries:						
Commercial and agricultural		9	33	8	10	15
Real estate – construction		-	56	98	16	17
Real estate – mortgage		147	23	81	23	185
Consumer and other		38	22	34	57	32
Net (charge-offs) recoveries		(283)	(184)	7	(580)	(700)
Allowance for loan losses, ending	\$	3,495 \$	3,453 \$	3,420 \$	3,418 \$	4,185
Ratio of net charge-offs during the period						
to average loans outstanding during the period	_	0.06%	0.04%	0.00%	0.26%	0.32%

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

Balance at the end of the period applicable to:	Decembe	r 31, 2018 % of Loans to Total Loans	December	% of Loans to Total Loans		December Amount	% of Loans to Total Loans
Commercial and agricultural Real estate – construction Real estate – mortgage Consumer and other Total	\$ 281 246 2,874 94 3,495	6.99% 6.23% 82.99% 3.79% 100.00%	\$ 282 239 2,852 80 3,453	6.04% 6.00% 84.29% 3.67% 100.00%	_	210 319 2,783 108 3,420	6.33% 6.42% 84.78% 2.47% 100.00%
			 December	r 31, 2015 % of	_	December	r 31, 2014 % of
Balance at the end of the period applicable to:			 December		_	December	

#### 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, 2018 and 2017 is as follows:

		2018	 2017
Commitments to extend credit	\$	76,977	\$ 56,912
Standby letters of credit		1,227	 1,106
	<u>\$</u>	78,204	\$ 58,018

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 11.6% at December 31, 2018 compared to 12.4% at December 31, 2017. 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, 2018. 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, 2018, 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, 2018  Maturities/Repricing									
		1 to 3 Months		4 to 12 Months		13 to 60 Months		Over 60 Months		Total
Interest-Earning Assets:										_
Interest bearing deposits	\$	12,159 \$	\$	-	\$	-	\$	-	\$	12,159
Federal funds sold		18,990		-		-		-		18,990
Investments		1,447		701		14,767		28,513		45,428
Loans		93,506		48,009		315,668		79,282		536,465
Total	\$	126,102 \$	\$	48,710	\$	330,435	\$	107,795	\$	613,042
Interest-Bearing Liabilities:										
Interest-bearing DDA accounts	\$	77,861 \$	\$	-	\$	-	\$	-	\$	77,861
Money market		54,584		-		-		-		54,584
Savings		129,114		-		-		-		129,114
Time deposits		22,904		51,459		104,966		814		180,143
Borrowings		<u> </u>								<u> </u>
Total	\$	284,463 \$	\$	51,459	\$	104,966	\$	814	\$	441,702
Interest sensitivity gap Cumulative interest	\$	(158,361) \$	\$	(2,749)	\$	225,469	\$	106,981	\$	171,340
sensitivity gap	\$	(158,361) \$	\$	(161,110)	\$	64,359	\$	171,340	\$	171,340
Ratio of sensitivity gap to total earning assets		-25.8%		-0.4%		36.8%		17.5%		27.9%
Cumulative ratio of sensitivity gap to total earning assets		-25.8%		-26.3%		10.5%		27.9%		27.9%

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, 2018.

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 Change Change percentage	\$ \$	23,857 \$ (3,144) \$ -11.64%	24,473 \$ (2,528) \$ -9.36%	25,814 \$ (1,187) \$ -4.40%	27,001 \$ - \$	26,972 \$ (29) \$ -0.11%	26,977 \$ (24) \$ -0.09%	- )
Market Value of Equity	\$	97,463 \$	106,535 \$	119,116 \$	128,790 \$	130,531 \$	129,122 \$	126,403

#### **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** 

	2018	2017	2016
Return on average assets	0.75%	0.44%	0.55%
Return on average equity	7.02%	4.28%	5.62%
Dividend payout ratio	24.81%	33.09%	19.56%
Average equity to average assets	10.66%	10.32%	9.78%

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# Honoring Carl Richardson

I will miss Mr. Richardson. He was such a kind man. I met him at Christmas time. It was right before Christmas and a pick-up truck pulled up to our branch. This man jumped out of his truck with a big smile on his face and carrying a Christmas tin. He came into the branch and said "Hi! My name is Carl Richardson. I am a member of the Board of Directors of Skyline National Bank. I am here to wish you all a very Merry Christmas and to thank you for all your hard work. We appreciate what you do every day to help us be successful!" He gave us a tin of peanuts and M+Ms and walked around, taking the time to speak to each one of us. He asked me what I did at the bank and thanked me for my service. I will never forget him. Whenever I think about what it means to be Always Our Best, every day, I will always think of Mr. Richardson.

Carl Richardson passed away on August 6, 2018, at the age of 73. He had literally devoted his entire adult life to our bank, our communities, our employees, customers and shareholders.

Carl joined Grayson National Bank – the predecessor to Skyline National Bank – on June 27, 1965, just two days before his 20th birthday. He started his banking career in the Bookkeeping Department.

He next became the manager of our branch in East Independence, but transferred back to the bank's main office at 113 West Main Street in Independence as a loan officer.

Carl became President & CEO in 1991 and served until his retirement in 2000. He was a Director of Grayson Bankshares, and then Parkway Acquisition Corp. from 1976 until his death in 2018.

"Carl was a thoughtful leader who made quality decisions," stated Director and former CEO Jacky Anderson. "He taught me to think things through. Our employees were always #1 with Carl, and he passed that priority on to me. Carl was my friend, my mentor, my brother, and my father. I will always remember and miss him."

Carl was truly the embodiment of our values at Skyline National Bank. He has left his mark on us, and our communities. He will always be missed; but never forgotten.

What we do here at Skyline National Bank is more than just meeting needs and growing businesses; doing good and being our best elevates community. We take on the challenges of our customers, craft solutions, and express kindness and enthusiasm in all that we do. The following values guide our every action.

 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.

