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NATIONAL BANKSHARES INC
Form 10-K
March 14, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2005

OR

Transition Report Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number: 0-15204

National Bankshares, Inc.
(Exact name of registrant as specified in its charter)

Virginia (State of Incorporation) 54-1375874 (I.R.S. Employer Identification No.)
101 Hubbard Street
Blacksburg, Virginia, 24060
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code 540-951-6300

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered Pursuant to Section 12(g) of the Act:
Common Stock, Par Value \$2.50 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

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The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by directors and executive officers of the registrant) on June 30, 2005 (the last business day of the most recently completed second fiscal quarter) was approximately \$147,691,809. As of February 15, 2006, the registrant had 3,506,587 shares of voting common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference into the Part of the Form 10-K indicated.

| Document | Part of Form 10-K into which incorporated |
|---|---|
| National Bankshares, Inc. 2005 Annual Report to Stockholders | Part II |
| National Bankshares, Inc. Proxy Statement for the 2006 Annual Meeting of Stockholders | Part III |

1

Table of Contents

| Part I | Page |
|---|------|
| Item 1. Business | 3 |
| Item 1A. Risk Factors | 11 |
| Item 1B. Unresolved Comments | 11 |
| Item 2. Properties | 11 |
| Item 3. Legal Proceedings | 12 |
| Item 4. Submission of Matters to a Vote of Security Holders | 12 |
| Part II | |
| Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities | 12 |
| Item 6. Selected Financial Data | 13 |
| Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations | 14 |
| Item 7A. Quantitative and Qualitative Disclosures About Market Risk | 34 |
| Item 8. Financial Statements and Supplementary Data | 35 |
| Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures | 60 |
| Item 9A. Controls and Procedures | 60 |
| Item 9B. Other Information | 61 |
| Part III | |
| Item 10. Directors and Executive Officers of the Registrant | 61 |
| Item 11. Executive Compensation | 61 |
| Item 12. Security Ownership of Certain | 62 |

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| | | |
|----------------------|---|----|
| Item 13. | Beneficial Owners and Management Certain Relationships and Related Transactions | 62 |
| Item 14. | Principal Accounting Fees and Services | 62 |
| Part IV | | |
| Item 15. | Exhibits and Financial Statement Schedules | 63 |
| Signatures | | 64 |
| Index of Exhibits | | 69 |

2

Part I

\$ In thousands, except per share data.

Item 1. Business

History and Business

National Bankshares, Inc. (Bankshares or NBI) is a financial holding company organized under the laws of Virginia in 1986 and registered under the Bank Holding Company Act (BHCA). Bankshares conducts the majority of its business operations through its two wholly-owned bank subsidiaries, The National Bank of Blacksburg (NBB) and Bank of Tazewell County (BTC), and through National Bankshares Financial Services, Inc. (NBFS), doing business as National Bankshares Investment Services and National Bankshares Insurance Services, collectively referred to as "The Company". In late 2005, BTC agreed to merge with and into NBB. The transaction is expected to close in the second quarter of 2006.

National Bankshares, Inc. posts all reports required to be filed under the Securities Exchange Act of 1934 on its web site at www.nationalbankshares.com.

The National Bank of Blacksburg

The National Bank of Blacksburg was originally chartered as the Bank of Blacksburg in 1891. Its state charter was converted to a national charter in 1922 and it became The National Bank of Blacksburg. NBB operates a full-service banking business from its headquarters in Blacksburg, Virginia, and its fourteen area branch offices. NBB offers general retail and commercial banking services to individuals, businesses, local government units and institutional customers. These products and services include accepting deposits in the form of checking accounts, money market deposit accounts, interest-bearing demand deposit accounts, savings accounts and time deposits; making real estate, commercial, revolving, consumer and agricultural loans; offering letters of credit; providing other consumer financial services, such as automatic funds transfer, collections, night depository, safe deposit, travelers checks, savings bond sales and utility payment services; and providing other miscellaneous services normally offered by commercial banks. NBB also conducts a general trust business. Through its trust operation, NBB offers a variety of personal and corporate trust services.

NBB makes loans in all major loan categories, including commercial, commercial and residential real estate, construction and consumer loans.

At December 31, 2005, NBB had total assets of \$488,595. Total deposits at

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this date were \$434,727. NBB's net income for 2005 was \$8,969, which produced a return on average assets of 1.87% and a return on average stockholders' equity of 17.84%. Refer to Note 12, of the Notes to Consolidated Financial Statements for NBB's risk-based capital ratios.

Bank of Tazewell County

The antecedents of BTC are in a charter issued on September 28, 1889 for Clinch Valley Bank. On December 22, 1893, a second charter was issued in substantially the same form for Bank of Clinch Valley. In 1929, Bank of Clinch Valley merged with Farmers National Bank under the charter of the former, and the name of the new institution became Farmers Bank of Clinch Valley. Bank of Tazewell County resulted from the 1964 merger of Bank of Graham, Bluefield, Virginia with Farmers Bank of Clinch Valley. BTC merged with Bankshares in 1996. BTC provides general retail and commercial banking services to individuals, businesses and local government units. These services include commercial, real estate and consumer loans. Deposit accounts offered include demand deposit accounts, interest-bearing demand deposit accounts, money market deposit accounts, savings accounts and certificates of deposit. Other services include automatic funds transfer, collections, night depository, safe deposit, travelers checks, savings bond sales and utility payment services; and providing other miscellaneous services normally offered by commercial banks. BTC also conducts a general trust business.

At December 31, 2005, BTC had total assets of \$348,045. Total deposits at this same date were \$311,016. BTC's net income for 2005 was \$3,527, which produced a return on average assets of 1.05% and a return on average stockholders' equity of 9.88%. Refer to Note 12, of the Notes to Consolidated Financial Statements for BTC's risk-based capital ratios.

National Bankshares Financial Services

On April 9, 2001, National Bankshares Financial Services Inc., a wholly-owned subsidiary, began offering non-deposit investment products and insurance products for sale to the public. NBFS is working with Bankers Insurance, LLC, a joint effort of Virginia banks originally sponsored by the Virginia Bankers Association. NBFS offers investment services through Bankers Investments, LLC.

Commercial Loans

NBB and BTC make both secured and unsecured loans to businesses and to individuals for business purposes. Loan requests are granted based upon several factors including credit history, past and present relationships with the bank, marketability of collateral and the cash flow of the borrowers. Unsecured commercial loans must be supported by a satisfactory balance sheet and income statement. Collateralized business loans may be secured by a security interest in marketable equipment, accounts receivable, business equipment and/or general

3

intangibles of the business. In addition, or as an alternative, the loan may be secured by a deed of trust lien on business real estate.

The risks associated with commercial loans are related to the strength of the individual business, the value of loan collateral and the general health of the economy.

Residential Real Estate Loans

Loans secured by residential real estate are originated by both bank subsidiaries. NBB sells a substantial percentage of the residential real estate loans it originates in the secondary market on a servicing released basis. There

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are occasions when a borrower or the real estate does not qualify under secondary market criteria, but the loan request represents a reasonable credit risk. Also, an otherwise qualified borrower may choose not to have their mortgage loan sold. On these occasions, if the loan meets NBB's internal underwriting criteria, the loan will be closed and placed in NBB's portfolio. Residential loans originated by BTC are held in the bank's loan portfolio. In its secondary market operations, NBB participates in insured loan programs sponsored by the Department of Housing and Urban Development, the Veterans Administration and the Virginia Housing Development Authority.

Residential real estate loans carry risk associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

Construction Loans

NBB makes loans for the purpose of financing the construction of business and residential structures to financially responsible business entities and individuals. These loans are subject to the same credit criteria as commercial and residential real estate loans. Although BTC offers construction loans, its involvement in this area of lending is more limited than NBB's due to the nature of its market area.

In addition to the risks associated with all real estate loans, construction loans bear the risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may at any point in time be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be the bank's loan customer, is unable to finish the construction project as planned because of financial pressures unrelated to the project. Loans to customers that are made as permanent financing of construction loans may likewise under certain circumstances be affected by external financial pressures.

Consumer Loans

NBB and BTC routinely make consumer loans, both secured and unsecured. The credit history, cash flow and character of individual borrowers is evaluated as a part of the credit decision. Loans used to purchase vehicles or other specific personal property and loans associated with real estate are usually secured with a lien on the subject vehicle or property.

Negative changes in a customer's financial circumstances due to a large number of factors, such as illness or loss of employment, can place the repayment of a consumer loan at risk. In addition, deterioration in collateral value can add risk to consumer loans.

Sales and Purchases of Loans

NBB and BTC will occasionally buy or sell all or a portion of a loan. These purchases and sales are in addition to the secondary market residential mortgage loans regularly sold by NBB.

Both banks will consider selling a loan or a participation in a loan, if: (i) the full amount of the loan will exceed the bank's legal lending limit to a single borrower; (ii) the full amount of the loan, when combined with a borrower's previously outstanding loans, will exceed the bank's legal lending limit to a single borrower; (iii) the Board of Directors or an internal Loan Committee believes that a particular borrower has a sufficient level of debt with the bank; (iv) the borrower requests the sale; (v) the loan to deposit ratio is at or above the optimal level as determined by bank management; and/or (vi) the loan may create too great a concentration of loans in one particular location or in one particular type of loan.

The banks will consider purchasing a loan, or a participation in a loan, from another financial institution (including from another subsidiary of the Company) if the loan meets all applicable credit quality standards and (i) the bank's loan to deposit ratio is at a level where additional loans would be

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desirable; and/or (ii) a common customer requests the purchase.

Operating Revenue

The following table sets forth, for the three fiscal years ended December 31, 2005, 2004 and 2003, the percentage of total operating revenue contributed by each class of similar services which contributed 15% or more of total operating revenues of the Company during these periods.

4

| Period | Class of Service | Percentage of Total Revenues |
|-------------------|----------------------------|------------------------------|
| ----- | ----- | ----- |
| December 31, 2005 | Interest and Fees on Loans | 62.71% |
| | Interest on Investments | 21.96% |
| December 31, 2004 | Interest and Fees on Loans | 61.30% |
| | Interest on Investments | 23.60% |
| December 31, 2003 | Interest and Fees on Loans | 68.59% |
| | Interest on Investments | 23.35% |

Market Area

The National Bank of Blacksburg Market Area

NBB's primary market area consists of all of Montgomery County, all of Giles County, all of Pulaski County, the City of Radford, the City of Galax and adjacent portions of Carroll and Grayson Counties, Virginia. This area includes the towns of Blacksburg and Christiansburg in Montgomery County, the towns of Pearisburg, Pembroke, Narrows and Rich Creek, in Giles County, and the towns of Dublin and Pulaski in Pulaski County. The local economy is diverse and is oriented toward higher education, retail and service, light manufacturing and agriculture.

Montgomery County's largest employer is Virginia Polytechnic Institute and State University (VPI & SU) located in Blacksburg. VPI & SU is the Commonwealth's land grant college and also its largest university. Employment at VPI & SU has remained relatively stable over the past three years, and it is not expected to change materially in the next few years. A second state supported university, Radford University, is located in NBB's service area. It too has provided stable employment opportunities in the region.

Giles County's primary employer is the Celanese plant, a manufacturer of acetate fibers. Employment at this plant remained relatively stable until the 3rd quarter of 2004. At that time 300 employees, or approximately one tenth of its work force, were laid off.

Pulaski County's major employer is the Volvo Heavy Trucks production facility. Employment trends at this facility have been stable over the past three years. The county also has several large furniture plants, most notably Pulaski Furniture. Furniture manufacturing has recently been negatively impacted by growing furniture imports.

The City of Galax is located in the Virginia-North Carolina furniture-manufacturing region. Three furniture companies, Vaughan Bassett Furniture Company, Vaughan Furniture Company, Inc. and Webb Furniture Company together employ the largest percentage of the area's work force. Furniture manufacturing has been negatively affected, and Vaughan Furniture recently announced the closing of one of its two plants in the community.

Several other small manufacturing concerns are located in Montgomery, Giles and Pulaski Counties and in the City of Galax. These concerns manufacture diverse products and are not dependent on one sector of the economy. Agriculture and tourism are also important to the region, especially in Giles County and in the area near Galax.

Montgomery County has developed into a regional retail center, with the

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construction of several large shopping areas. Two area hospitals, each of which is affiliated with different large health care systems, have constructed additional facilities attracting health care providers to Montgomery County, making it a center for basic health care services. VPI & SU's Corporate Research Center has brought small high tech companies to Blacksburg, and further expansion is planned.

NBB's primary market area offers the advantages of a good quality of life, scenic beauty, moderate climate and the cultural attractions of two major universities. The region has marketed itself as a retirement destination, and it has had some recent success attracting retirees, particularly from the Northeast and urban Northern Virginia. These marketing efforts are expected to continue.

Bank of Tazewell County Market Area

Most of BTC's business originates from Tazewell County, Virginia and the continuous portions of Mercer County and McDowell, West Virginia. This includes the towns of Tazewell, Richlands and Bluefield, Virginia and Bluefield, West Virginia. BTC also has offices located in the towns of Wytheville, Marion and Abingdon located in Wythe, Smyth and Washington Counties, Virginia, respectively. BTC's primary market area has largely depended on the coal mining industry and farming for its economic base. In recent years, coal companies have mechanized, reducing the number of individuals required for the production of coal. However, there are still a number of support industries for the coal mining business that continue to provide employment in the area. Additionally, several new businesses have been established in the area. Recently announced economic development plans in neighboring Russell County are expected to have a positive impact in western Tazewell County in the next few years. Real estate values remain stable and comparable to other areas in Southwest Virginia. BTC's expanded market areas in Wythe, Smyth and Washington Counties have a diverse economic base, with manufacturing, agriculture, education and service industries all represented.

5

Competition

The banking and financial service business in Virginia, generally, and in NBB's and BTC's market areas specifically, is highly competitive. The increasingly competitive environment is a result of changes in regulation, changes in technology and product delivery systems and new competition from non-traditional financial services. The Company's bank subsidiaries compete for loans and deposits with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, money market funds, credit unions, insurance companies and other nonbank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than NBB and BTC. In order to compete, NBB and BTC rely upon service-based business philosophies, personal relationships with customers, specialized services tailored to meet customers' needs and the convenience of office locations. In addition, the banks are generally competitive with other financial institutions in their market areas with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts.

Registrant's Organization and Employment

Bankshares, NBB, BTC and NBFS are organized in a holding company/subsidiary structure. Until January 1, 2002, Bankshares had no employees, except for officers, and it conducted substantially all of its operations through its subsidiaries. Until January 1, 2002, all compensation paid to Bankshares

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officers was paid by the subsidiary banks, except for fees paid to Chairman, President and Chief Executive Officer James G. Rakes for his service as a director of the Company. In 2002, several administrative functions that serve multiple subsidiaries were moved to the holding company level. These functions include audit, compliance, loan review and human resources. Employees performing these functions who were formerly employed at the bank level are now employed at the holding company level.

At December 31, 2005, NBB employed 145 full time equivalent employees at its main office, operations center and branch offices. BTC at December 31, 2005 employed 96.5 full time equivalent employees in its various offices and operational areas. Bankshares had 18 and NBFS had 3 full time employees at December 31, 2005.

On December 20, 2005 NBB and BTC entered into an agreement to merge, in which BTC will be merged into NBB. The transaction is expected to close in the second quarter. As each bank's market area has expanded, the two service areas have grown closer. Management believes that a single bank franchise will enhance customer service by permitting customers to handle transactions at a larger number of offices. In addition, economies of scale should be realized in purchasing advertising and marketing and other operational areas.

Certain Regulatory Considerations

Bankshares, NBB and BTC are subject to various state and federal banking laws and regulations which impose specific requirements or restrictions on and provide for general regulatory oversight with respect to virtually all aspects of operations. As a result of the substantial regulatory burdens on banking, financial institutions, including Bankshares, NBB and BTC, are disadvantaged relative to other competitors who are not as highly regulated, and their costs of doing business are much higher. The following is a brief summary of the material provisions of certain statutes, rules and regulations which affect Bankshares, NBB and/or BTC. This summary is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below and is not intended to be an exhaustive description of the statutes or regulations which are applicable to the businesses of Bankshares, NBB and/or BTC. Any change in applicable laws or regulations may have a material adverse effect on the business prospects of Bankshares, NBB and/or BTC.

National Bankshares, Inc.

Bankshares is a bank holding company within the meaning of the BHCA and Chapter 13 of the Virginia Banking Act, as amended (the Virginia Banking Act). The activities of Bankshares also are governed by the Gramm-Leach-Bliley Act of 1999.

The Bank Holding Company Act. The BHCA is administered by the Federal Reserve Board, and Bankshares is required to file with the Federal Reserve Board an annual report and any additional information the Federal Reserve Board may require under the BHCA. The Federal Reserve Board also is authorized to examine Bankshares and its subsidiaries. The BHCA requires every bank holding company to obtain the approval of the Federal Reserve Board before (i) it or any of its subsidiaries (other than a bank) acquires substantially all the assets of any bank; (ii) it acquires ownership or control of any voting shares of any bank if after the acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of the bank; or (iii) it merges or consolidates with any other bank holding company.

The BHCA and the Change in Bank Control Act, together with regulations promulgated by the Federal Reserve Board, require that, depending on the particular circumstances, either Federal Reserve Board approval must be obtained or notice must be furnished to the Federal Reserve Board and not disapproved prior to any person or company acquiring "control" of a bank holding company, such as Bankshares, subject to certain exemptions. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of Bankshares. Control is rebuttably presumed to exist if a

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person acquires 10% or more, but less than 25%, of any class of voting securities of Bankshares. The regulations provide a procedure for challenging the rebuttable control presumption.

6

Under the BHCA, a bank holding company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in nonbanking activities, unless the Federal Reserve Board, by order or regulation, has found those activities to be so closely related to banking or managing or controlling banks as to be incident to banking. Under recent amendments to the BHCA, included in the Gramm-Leach-Bliley Act of 1999 (see below), any bank holding company, all the depository institution subsidiaries of which are well-capitalized, well managed (as those terms are defined in the BHCA) and have a satisfactory or better rating under the Community Reinvestment Act as of their last examination, may file an election with the Federal Reserve Board to become a Financial Holding Company. A Financial Holding Company may engage in any activity that is (i) financial in nature (ii) incidental to a financial activity or (iii) complementary to a financial activity. The BHCA provides a long list of "financial activities", including: insurance underwriting; securities dealing and underwriting; providing financial, investment or economic arising services; and merchant banking activities. Financial Holding Companies may also engage in other activities that the Federal Reserve Board has determined are permissible under the BHCA, by regulation or order. Bankshares is a financial holding company.

The Federal Reserve Board imposes certain capital requirements on Bankshares under the BHCA, including a minimum leverage ratio and a minimum ratio of "qualifying" capital to risk-weighted assets. Subject to its capital requirements and certain other restrictions, Bankshares can borrow money to make a capital contribution to NBB or BTC, and these loans may be repaid from dividends paid from NBB or BTC to Bankshares (although the ability of NBB or BTC to pay dividends are subject to regulatory restrictions). Bankshares has not done this. Bankshares can raise capital for contribution to NBB and BTC by issuing securities without having to receive regulatory approval, subject to compliance with federal and state securities laws.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act (the GLBA), enacted on November 12, 1999, broadly rewrote financial services legislation. The GLBA permits significant combinations among different sectors of the financial services industry; allows for significant expansion of financial service activities by Bank holding companies and provides for a regulatory framework by various governmental authorities responsible for different financial activities; and offers certain financial privacy protections to consumers. The GLBA repealed affiliation and management interlock prohibitions of the Depression-era Glass-Steagall Act and, by amending the Bank Holding Company Act, the GLBA added new substantive provisions to the non-banking activities permitted under the BHCA with the creation of the financial holding company. The GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. The GLBA permits affiliations between banks and securities firms within the same holding company structure, and the Act permits financial holding companies to directly engage in a broad range of securities and merchant banking activities.

The Gramm-Leach-Bliley Act has led to important changes in the manner in which financial services are delivered in the United States. Bank holding companies and their subsidiary banks are able to offer a much broader array of financial services; however, there is greater competition in all sectors of the financial services market.

The Virginia Banking Act. All Virginia bank holding companies must register with the Virginia State Corporation Commission (the Commission) under the Virginia Banking Act. A registered bank holding company must provide the Commission with information with respect to the financial condition, operations, management and intercompany relationships of the holding company and its

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subsidiaries. The Commission also may require such other information as is necessary to keep itself informed about whether the provisions of Virginia law and the regulations and orders issued under Virginia law by the Commission have been complied with, and may make examinations of any bank holding company and its subsidiaries. The Virginia Banking Act allows bank holding companies located in any state to acquire a Virginia bank or bank holding company if the Virginia bank or bank holding company could acquire a bank holding company in their state and the Virginia bank or bank holding company to be acquired has been in existence and continuously operated for more than two years. The Virginia Banking Act permits bank holding companies from throughout the United States to enter the Virginia market, subject to federal and state approval.

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002. It enacted sweeping reforms of the federal securities laws intended to protect investors by improving the accuracy and reliability of corporate disclosures. Compliance with this complex legislation and with subsequent Securities and Exchange Commission rules has since been a major focus of all public corporations in the United States, including Bankshares. Among the many significant provisions of the Sarbanes-Oxley Act, Section 404 and related Securities and Exchange Commission rules created increased scrutiny by internal and external auditors of Bankshares' systems of internal controls over financial reporting. These ongoing and extensive efforts are designed to insure that Bankshares' internal controls are effective in terms of both design and operation.

NBB and BTC

General. NBB is a national banking association incorporated under the laws of the United States and is subject to examination by the Office of the Comptroller of the Currency (the OCC). Deposits in NBB are insured by the FDIC up to a maximum amount (generally \$100,000 per depositor, subject to aggregation rules). The OCC and the FDIC regulate or monitor all areas of NBB's operations, including security devices and procedures, adequacy of capitalization and loss reserves, loans, investments, borrowings, deposits, mergers, issuances of securities, payment of dividends, interest rates payable on deposits, interest rates or fees chargeable on loans, establishment of branches, corporate reorganizations and maintenance of books and records. The OCC requires NBB to maintain certain capital ratios. NBB is required by the OCC to prepare quarterly reports on NBB's financial condition and to conduct an annual audit of its financial affairs in compliance with minimum standards and procedures prescribed by the OCC. NBB also is required by the OCC to adopt internal control structures and procedures in order to safeguard assets and monitor and reduce risk exposure. While appropriate for safety and soundness of banks, these requirements impact banking overhead costs.

7

BTC is organized as a Virginia-chartered banking corporation and is regulated and supervised by the Bureau of Financial Institutions (BFI) of the Virginia State Corporation Commission. In addition, as a federally insured bank that is a member of the Federal Reserve System, BTC is regulated and supervised by the Federal Reserve Board, which serves as its primary federal regulator and is subject to certain regulations promulgated by the FDIC. Under the provisions of federal law, federally insured banks are subject, with certain exceptions, to certain restrictions on extensions of credit to their affiliates, on investments in the stock or other securities of affiliates and on the taking of such stock or securities as collateral from any borrower. In addition, these banks are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or the providing of any property of service.

The Virginia State Corporation Commission and the Federal Reserve Board conduct regular examinations of BTC reviewing the adequacy of the loan loss reserves, quality of the loans and investments, propriety of management

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practices, compliance with laws and regulations and other aspects of the bank's operations. In addition to these regular examinations, Virginia chartered banks must furnish to the Federal Reserve Board quarterly reports containing detailed financial statements and schedules.

Community Reinvestment Act. NBB and BTC are subject to the provisions of the Community Reinvestment Act of 1977 (the CRA), which requires the appropriate federal bank regulatory agency, in connection with its regular examination of a bank, to assess the bank's record in meeting the credit needs of the community served by the bank, including low and moderate-income neighborhoods. The focus of the regulations is on the volume and distribution of a bank's loans, with particular emphasis on lending activity in low and moderate-income areas and to low and moderate-income persons. The regulations place substantial importance on a bank's product delivery system, particularly branch locations. The regulations require banks, including NBB and BTC, to comply with significant data collection requirements. The regulatory agency's assessment of the bank's record is made available to the public. Further, this assessment is required for any bank which has applied to, among other things, establish a new branch office that will accept deposits, relocate an existing office, or merge, consolidate with or acquire the assets or assume the liabilities of a federally regulated financial institution. It is likely that banks' compliance with the CRA, as well as other fair lending laws, will face ongoing government scrutiny and that costs associated with compliance will continue to increase.

Both NBB and BTC have received "Satisfactory" CRA ratings in the last examination by bank regulators. Federal Deposit Insurance Corporation Improvement Act of 1991. The difficulties encountered nationwide by financial institutions during 1990 and 1991 prompted federal legislation designed to reform the banking industry and to promote the viability of the industry and of the deposit insurance system. FDICIA, which became effective on December 19, 1991, bolsters the deposit insurance fund, tightens bank regulation and trims the scope of federal deposit insurance.

The legislation bolsters the bank deposit insurance fund with \$70 billion in borrowing authority and increases to \$30 billion from \$5 billion the amount the FDIC can borrow from the U.S. Treasury to cover the cost of bank failures. The loans, plus interest, would be repaid by premiums that banks pay on domestic deposits over the next fifteen years.

Among other things, FDICIA requires the federal banking agencies to take "prompt corrective action" in respect to banks that do not meet minimum capital requirements. FDICIA establishes five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized."

If a depository institution's principal federal regulator determines that an otherwise adequately capitalized institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, it may require the institution to submit a corrective action plan, restrict its asset growth and prohibit branching, new acquisitions and new lines of business. An institution's principal federal regulator may deem the institution to be engaging in an unsafe or unsound practice if it receives a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent examination.

Among other possible sanctions, an undercapitalized depository institution may not pay dividends and is required to submit a capital restoration plan to its principal federal regulator. In addition, its holding company may be required to guarantee compliance with the capital restoration plan under certain circumstances. If an undercapitalized depository institution fails to submit or implement an acceptable capital restoration plan, it can be subject to more severe sanctions, including an order to sell sufficient voting stock to become adequately capitalized. More severe sanctions and remedial actions can be mandated by the regulators if an institution is considered significantly or critically undercapitalized.

In addition, FDICIA requires regulators to draft a new set of non-capital measures of bank safety, such as loan underwriting standards and minimum earnings levels. The legislation also requires regulators to perform annual on-site bank examinations, places limits on real estate lending by banks and

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tightens auditing requirements. The regulators have adopted safety and soundness standards as required by FDICIA in the following areas: (i) operational and managerial; (ii) asset quality earnings and stock valuation; and (iii) employee compensation.

FDICIA reduces the scope of federal deposit insurance. The most significant change ended the "too big to fail" doctrine, under which the government protects all deposits in most banks, including those exceeding the \$100,000 insurance limit. The FDIC's ability to reimburse uninsured deposits--those over \$100,000 and foreign deposits--has been sharply limited. Since December 1993, the Federal Reserve Board's ability to finance undercapitalized banks with extended loans from its discount window has been restricted. In addition, only the best capitalized banks will be able to offer insured brokered deposits without FDIC permission or to insure accounts established under employee pension plans.

Branching. In 1986, the Virginia Banking Act was amended to remove the geographic restrictions governing the establishment of branch banking offices. Subject to the approval of the appropriate federal and state bank regulatory authorities, BTC as a state bank may establish a branch office anywhere in Virginia. With state banking regulatory and Federal Reserve Bank approval, BTC is able to acquire existing banking operations in the state.

National banks, like NBB, are required by the National Bank Act to adhere to

8

branch banking laws applicable to state banks in the states in which they are located. Under current Virginia law, NBB may open branch offices throughout Virginia with the prior approval of the OCC. In addition, with prior approval of the OCC, NBB will be able to acquire existing banking operations in Virginia.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) allows bank holding companies to acquire banks in any state, without regard to state law, except that if the state has a minimum requirement for the amount of time a bank must be in existence, that law must be preserved. Under the Virginia Banking Act, a Virginia bank or all of the subsidiaries of Virginia holding companies sought to be acquired must have been in continuous operation for more than two years before the date of such proposed acquisition. The Interstate Act also permits banks to acquire out-of-state branches through interstate mergers, if the state has not opted out of interstate branching. De novo branching, where an out-of-state bank sets up a new branch in another state, requires a state's specific approval. An acquisition or merger is not permitted under the Interstate Act if the bank, including its insured depository affiliates, will control more than 10% of the total amount of deposits of insured depository institutions in the United States, or will control 30% or more of the total amount of deposits of insured depository institutions in any state.

Virginia has, by statute, elected to opt-in fully to interstate branching under the Interstate Act. Under the Virginia statute, Virginia state banks may, with the approval of the Virginia State Corporation Commission, establish and maintain a de novo branch or acquire one or more branches in a state other than Virginia, either separately or as part of a merger. Procedures also are established to allow out-of-state domiciled banks to establish or acquire branches in Virginia, provided the "home" state of the bank permits Virginia banks to establish or acquire branches within its borders. The activities of these branches are subject to the same laws as Virginia domiciled banks, unless such activities are prohibited by the law of the state where the bank is organized. The Virginia State Corporation Commission has the authority to examine and supervise out-of-state state banks to ensure that the branch is operating in a safe and sound manner and in compliance with the laws of Virginia. The Virginia statute authorizes the Bureau of Financial Institutions to enter into cooperative agreements with other state and federal regulators for the examination and supervision of out-of-state banks with Virginia operations, or Virginia domiciled banks with operations in other states. Likewise, national banks, with the approval of the OCC, may branch into and out of the state of

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Virginia. Any Virginia branch of an out-of-state national bank is subject to Virginia law (enforced by the OCC) with respect to intrastate branching, consumer protection, fair lending and community reinvestment as if it were a branch of a Virginia bank, unless preempted by federal law.

The Interstate Act permits banks and bank holding companies from throughout the United States to enter Virginia markets through the acquisition of Virginia institutions and makes it easier for Virginia bank holding companies and Virginia state and national banks to acquire institutions and to establish branches in other states. Competition in market areas served by the Company has increased as a result of the Interstate Act and the Virginia interstate banking statutes.

Deposit Insurance. The FDIC establishes rates for the payment of premiums by federally insured financial institutions. A Bank Insurance Fund (the BIF) is maintained for commercial banks, with insurance premiums from the industry used to offset losses from insurance payouts when banks fail. Beginning in 1993, insured depository institutions like NBB and BTC paid for deposit insurance under a risk-based premium system. Beginning in 1997, all banks, including NBB and BTC, were subject to an additional FDIC assessment which funds interest payments for bank issues to resolve problems associated with the savings and loan industry. This assessment will continue until 2018-2019. The assessment will vary over the period from 1.29 cents to 2.43 cents per \$100 of deposits.

USA Patriot Act. The USA Patriot Act became effective in late 2001. It was passed to facilitate the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The USA Patriot Act creates an obligation on banks to report customer activities that may involve terrorist activities or money laundering.

Government Policies. The operations of NBB and BTC are affected not only by general economic conditions, but also by the policies of various regulatory authorities. In particular, the Federal Reserve Board regulates money and credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve Board monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

Limits on Dividends and Other Payments. As a national bank, NBB, may not pay dividends from its capital; all dividends must be paid out of net profits then on hand, after deducting expenses, losses, bad debts, accrued dividends on preferred stock, if any, and taxes. In addition, a national bank is prohibited from declaring a dividend on its shares of common stock until its surplus equals its stated capital, unless there has been transferred to surplus no less than one-tenth of the bank's net profits of (i) the preceding two consecutive half-year periods (in the case of an annual dividend) or (ii) the preceding half-year period (in the case of a quarterly or semi-annual dividend). The approval of the OCC is required if the total of all dividends declared by a national bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus or to fund the retirement of preferred stock.

The OCC has promulgated regulations that became effective on December 13, 1990, which significantly affect the level of allowable dividend payments for national banks. The effect is to make the calculation of national banks' dividend-paying capacity consistent with generally accepted accounting principles. The allowance for loan and lease losses will not be considered an element of "undivided profits then on hand" and provisions to the allowance are treated as expenses and therefore not part of "net profits." Accordingly, a national bank with an allowance greater than its statutory bad debts may not include the excess in calculating undivided profits for dividend purposes. Further, a national bank may be able to use a portion of its earned capital surplus account as "undivided profits then on hand," depending on the composition of that account.

As a state member bank subject to the regulations of the Federal Reserve Board, BTC must obtain the approval of the Federal Reserve Board for any

dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits, as defined by the Federal Reserve Board, for that year, combined with its retained net profits for the preceding two years. In addition, a state member bank may not pay a dividend in an amount greater than its undivided profits then on hand after deducting its losses and bad debts. For this purpose, bad debts are generally defined to include the principal amount of loans which are in arrears with respect to interest by six months or more, unless such loans are fully secured and in the process of collection. Moreover, for purposes of this limitation, a state member bank is not permitted to add the balance in its allowance for loan losses account to its undivided profits then on hand; however, it may net the sum of its bad debts as so defined against the balance in its allowance for loan losses account and deduct from undivided profits only bad debts as so defined in excess of that account.

In addition, the Federal Reserve Board is authorized to determine, under certain circumstances relating to the financial condition of a state member bank, that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The payment of dividends that depletes a bank's capital base could be deemed to constitute such an unsafe or unsound practice. The Federal Reserve Board has indicated that banking organizations should generally pay dividends only out of current operating earnings.

Virginia law also imposes restrictions on the ability of BTC to pay dividends. A Virginia state bank is permitted to declare a dividend out of its "net undivided profits", after providing for all expenses, losses, interest and taxes accrued or due by the bank. In addition, a deficit in capital originally paid in must be restored to its initial level, and no dividend can be paid which could impair the bank's paid in capital. The Bureau of Financial Institutions further has authority to limit the payment of dividends by a Virginia bank if it determines the limitation is in the public interest and is necessary to ensure the bank's financial soundness.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provides that no insured depository institution may make any capital distribution (which would include a cash dividend) if, after making the distribution, the institution would not satisfy one or more of its minimum capital requirements.

Capital Requirements. The Federal Reserve Board has adopted risk-based capital guidelines which are applicable to Bankshares and BTC. The Federal Reserve Board guidelines redefine the components of capital, categorize assets into different risk classes and include certain off-balance sheet items in the calculation of risk-weighted assets. The minimum ratio of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit) is 8.0%. At least half of the total capital must be comprised of Tier 1 capital for a minimum ratio of Tier 1 Capital to risk-weighted assets of 4.0%. The remainder may consist of a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of loan and lease loss reserves. The OCC has adopted similar regulations applicable to NBB.

In addition, the Federal Reserve Board has established minimum leverage ratio (Tier 1 capital to total average assets less intangibles) guidelines that are applicable to Bankshares and BTC. The OCC has adopted similar regulations applicable to NBB. These guidelines provide for a minimum ratio of 4.0% for banks that meet certain specified criteria, including that they have the highest regulatory CAMELS rating and are not anticipating or experiencing significant growth and have well-diversified risk. All other banks will be required to maintain an additional cushion of at least 100 to 200 basis points, based upon their particular circumstances and risk profiles. The guidelines also provide that banks experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory

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levels, without significant reliance on intangible assets.

Bank regulators from time to time have indicated a desire to raise capital requirements applicable to banking organizations beyond current levels. In addition, the number of risks which may be included in risk-based capital restrictions, as well as the measurement of these risks, is likely to change, resulting in increased capital requirements for banks. Bankshares, NBB and BTC are unable to predict whether higher capital ratios would be imposed and, if so, at what levels and on what schedule.

Other Legislative and Regulatory Concerns

Other legislative and regulatory proposals regarding changes in banking and the regulation of banks, thrifts and other financial institutions are periodically considered by the executive branch of the federal government, Congress and various state governments, including Virginia. New proposals could significantly change the regulation of banks and the financial services industry. It cannot be predicted what might be proposed or adopted or how these proposals would affect the Company.

Other Business Concerns

The banking industry is particularly sensitive to interest rate fluctuations, as the spread between the rates which must be paid on deposits and those which may be charged on loans is an important component of profit. In addition, the interest which can be earned on a bank's invested funds has a significant effect on profits. Rising interest rates typically reduce the demand for new loans, particularly the real estate loans which represent a significant portion of NBB's and BTC's loan demand, as well as certain NBB loans in which BTC participates.

Company Website

National Bankshares maintains a website at www.nationalbankshares.com.

The Company makes available through its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the material is electronically filed with the Securities and Exchange Commission.

10

Item 1A. Risk Factors

If market interest rates rise, our net interest income can be negatively affected in the short term.

The direction and speed of interest rate changes affect our net interest margin and net interest income. In the short term, rising interest rates can negatively affect our net interest income, because our interest-bearing liabilities (generally deposits) reprice sooner than our interest-earning assets (generally loans).

If we do not maintain our capital requirements and our status as a "well-capitalized" financial holding company, there could be an adverse effect on the way in which we do business and on the confidence of our customers.

National Bankshares, Inc. and its bank subsidiaries are subject to regulatory capital adequacy guidelines. If the banks fail to meet capital adequacy guidelines, it could have a material effect on our financial condition and could subject us to a variety of enforcement actions, as well as impose restrictions on our business. If National Bankshares, Inc. fails to maintain the

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status of "well-capitalized", it could affect our status as a financial holding company and negatively impact our eligibility for a streamlined review process for acquisition proposals. In addition, it could lead to a decline in the confidence that our customers have in us and a reduction in the demand for our products and services.

If we are not in compliance with governmental regulation, we can be subject to fines, penalties or restrictions of our business.

Our businesses are subject to stringent regulation by federal and state governmental and regulatory agencies and self-regulatory organizations (including Nasdaq). In addition, our customers have a number of complex confidentiality and fiduciary requirements. We have established policies, procedures and systems that are designed to comply with these regulatory and operational risk requirements. However, as a financial services institution, we face complexity and costs related to our compliance efforts. We also face the potential for loss resulting from failed or inadequate internal processes and from external events, which could have a material impact on our results of operations. Adverse publicity and damage to our reputation from the failure or perceived failure to comply with legal, regulatory or capital requirements could affect our ability to comply with legal, regulatory or capital requirements could affect our ability to attract or maintain customers or maintain access to capital markets, or could result in enforcement actions, fines, penalties and lawsuits.

If there is a significant economic downturn in our region, our credit risk could be adversely affected and result in loss.

We do business in a small geographic area, and a large percentage of our loans are made in our market area. If the region suffers a significant or prolonged period of economic downturn, there is a greater likelihood that more of our customers could become delinquent on their loans or other obligations to us. This could result in higher levels of credit-related losses, which could adversely affect our performance.

If more competitors come into our market area, our business could suffer.

Financial services in our market area is highly competitive, with a number of commercial banks, credit unions, insurance companies and stockbrokers seeking to do business with our customers. If there is additional competition from new business or if our existing competitors focus more attention on our market, we could lose customers and our business could suffer.

If the disaster recovery plans that we have in place are not adequate to continue our operations in the event of a disaster, the business disruption can adversely impact our operations.

Natural or man-made disasters, such as fires, storms, terrorist or military actions could cause damage to our physical facilities, or could cause delays or disruptions to operational functions, including information processing or check settlements. In addition, our vendors could suffer from such events. Should these events affect us or the vendors with whom we do business, our results of operations could be negatively impacted.

Item 1B. Unresolved Staff Comments

There are none.

Item 2. Properties

Bankshares' headquarters and one branch office of NBB are located at 101 Hubbard Street, Blacksburg, Virginia. NBB's Main Office is at 100 South Main

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Street, Blacksburg, Virginia. In addition to the Bank's Main Office location and the Hubbard Street branch office, NBB owns thirteen branch offices: Three in the Town of Blacksburg; two in the Town of Christiansburg; three in the County of

11

Giles; three in Pulaski County; one in the City of Radford; and one in the City of Galax.

Bank of Tazewell County owns the land and buildings of seven of its eleven offices. The bank leases the land and buildings for four offices. The Main Office is located at 309 East Main Street, Tazewell, Virginia. Three additional branches are located in Tazewell, and two are located in Bluefield, Virginia. The bank also has branch offices in Richlands, Wytheville, Abingdon, Claypool Hill, and Marion, Virginia. Management believes that its existing facilities are adequate to meet present needs and any anticipated growth.

NBB owns all its computer and data processing hardware and is a licensee of the software it utilizes. BTC utilizes this same system for data processing.

Item 3. Legal Proceedings

Bankshares, NBB, BTC, and NBFS are not currently involved in any material pending legal proceedings, other than routine litigation incidental to NBB's and BTC's banking business.

Item 4. Submission of Matters to a Vote of Security Holders

None

Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the Nasdaq Capital Market under the symbol "NKSH". As of December 31, 2005, there were 949 record stockholders of Bankshares common stock. The following is a summary of the market price per share and cash dividend per share of the common stock of National Bankshares, Inc. for 2005 and 2004.

Common Stock Market Prices

| | 2005 | | 2004 | | Dividends per share | |
|----------------|----------|-------|----------|-------|---------------------|------|
| | High | Low | High | Low | 2005 | 2004 |
| First Quarter | \$ 53.06 | 45.15 | \$ 56.18 | 50.20 | --- | --- |
| Second Quarter | 48.75 | 43.76 | 50.44 | 37.43 | 0.70 | 0.70 |
| Third Quarter | 47.45 | 44.55 | 44.44 | 41.56 | --- | --- |
| Fourth Quarter | 47.25 | 45.24 | 53.98 | 43.40 | 0.72 | 0.72 |

NBI's primary source of funds for dividend payments is dividends from its

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subsidiaries, NBB and BTC. Bank regulatory agencies restrict dividend payments of the subsidiaries, as more fully disclosed in Note 11, of Notes to Consolidated Financial Statements.

The following table provides information about our purchases during the fourth quarter of 2005 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act.

| Fiscal Period | Total Number of Shares Purchased | Average Price Paid per Share (1) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2) | Approximate Value of May Purchase Plans on |
|---------------|----------------------------------|----------------------------------|--|--|
| October | 800 | \$ 46.63 | 5,600 | |
| November | 1,600 | \$ 46.26 | 7,200 | |
| December | 2,140 | \$ 47.35 | 9,340 | |

- 1) Average price per share includes commissions.
- 2) On May 12, 2005 the Board approved the repurchase of up to \$1 million of common stock in the period from June 1, 2005 through May 31, 2006.

12

Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries
Selected Consolidated Financial Data
\$ In thousands, except per share data.

| | | Years ended December 31, | | | | |
|--|---------------------------|--------------------------|-----------|-----------|-----------|-----------|
| | | 2005 | 2004 | 2003 | 2002 | 2001 |
| Selected Income Statement Data: | Interest income | \$ 45,380 | \$ 41,492 | \$ 41,081 | \$ 42,747 | \$ 45,522 |
| | Interest expense | 14,180 | 11,125 | 12,252 | 15,764 | 22,777 |
| | Net interest income | 31,200 | 30,367 | 28,829 | 26,983 | 22,750 |
| | Provision for loan losses | 567 | 1,189 | 1,691 | 2,251 | 1,400 |
| | Noninterest income | 7,613 | 7,142 | 6,186 | 5,712 | 5,200 |
| | Noninterest expense | 21,898 | 20,336 | 18,646 | 17,427 | 16,950 |
| | Income taxes | 3,924 | 3,754 | 3,236 | 3,003 | 2,280 |
| | Net income | 12,424 | 12,230 | 11,442 | 10,014 | 7,310 |
| Per Share Data: | Basic net income | 3.54 | 3.48 | 3.26 | 2.85 | 2.00 |
| | Diluted net income | 3.52 | 3.46 | 3.24 | 2.85 | 2.00 |
| | Cash dividends declared | 1.42 | 1.28 | 1.13 | 0.97 | 0.80 |
| | Book value per share | 26.19 | 24.75 | 22.94 | 20.82 | 18.50 |
| Selected | Loans, net | 487,162 | 472,199 | 401,428 | 404,247 | 394,040 |

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| | | | | | | |
|-------------|-------------------------------------|---------|---------|---------|---------|---------|
| Balance | Total securities | 272,541 | 250,708 | 230,154 | 219,294 | 191,477 |
| Sheet Data | Total assets | 841,498 | 796,154 | 708,560 | 684,935 | 644,627 |
| at End of | Total deposits | 745,649 | 705,932 | 625,378 | 608,271 | 576,617 |
| Year: | Stockholders' equity | 91,939 | 87,088 | 80,641 | 73,101 | 65,267 |
| ----- | | | | | | |
| Selected | Loans, net | 487,130 | 438,761 | 405,696 | 404,717 | 380,977 |
| Balance | Total securities | 261,743 | 250,305 | 229,004 | 191,493 | 188,807 |
| Sheet Daily | Total assets | 819,341 | 753,730 | 697,012 | 655,783 | 635,697 |
| Averages: | Total deposits | 724,015 | 665,627 | 616,823 | 583,298 | 569,137 |
| | Stockholders' equity | 90,470 | 84,479 | 77,486 | 69,895 | 63,467 |
| ----- | | | | | | |
| Selected | Return on average assets | 1.52% | 1.62% | 1.64% | 1.53% | 1.15% |
| Ratios: | Return on average equity | 13.73% | 14.48% | 14.77% | 14.33% | 11.53% |
| | Dividend payout ratio | 40.17% | 36.83% | 34.71% | 34.01% | 41.29% |
| | Average equity to average assets | 11.04% | 11.21% | 11.12% | 10.63% | 9.98% |
| ----- | | | | | | |

13

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations \$ In thousands, except per share data.

The purpose of this discussion is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries and other information included in this report.

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Company's actual results could differ materially from those set forth in the forward-looking statements.

Critical Accounting Policies

General

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. The Company uses historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, the timing of events that would impact the transactions could change.

Allowance for the Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and are estimable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, 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

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secondary market and the loan balance.

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

Core deposit intangibles

Effective January 1, 2002, the Company adopted Financial Accounting Standards Board Statement No. 142, Goodwill and Other Intangible Assets. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, Statement 142 requires that acquired intangible assets (such as core deposit intangibles) be separately recognized if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its estimated useful life. Branch acquisition transactions were outside the scope of the Statement and therefore any intangible asset arising from such transactions remained subject to amortization over their estimated useful life.

In October 2002, the Financial Accounting Standards Board issued Statement No. 147, Acquisitions of Certain Financial Institutions. The Statement amends previous interpretive guidance on the application of the purchase method of accounting to acquisitions of financial institutions, and requires the application of Statement No. 141, Business Combinations, and Statement No. 142 to branch acquisitions if such transactions meet the definition of a business combination. The provisions of the Statement do not apply to transactions between two or more mutual enterprises. In addition, the Statement amends Statement No. 144, Accounting for the Impairment of Long-Lived Assets, to include in its scope core deposit intangibles of financial institutions. Accordingly, such intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The Company has determined that the acquisitions that generated the intangible assets and goodwill on the consolidated balance sheets in the amount of \$9,958 and \$10,912 at December 31, 2003 and 2002, respectively, did not constitute the acquisition of a business, and therefore will continue to be amortized.

14

Overview

National Bankshares, Inc. (NBI) is a financial holding company, as defined in the Gramm-Leach-Bliley Act of 1999. Located in Southwest Virginia, it conducts operations primarily through two full service banking affiliates, the National Bank of Blacksburg (NBB) and Bank of Tazewell County (BTC). The banks are best characterized as community banks. It also has one nonbanking affiliate, National Bankshares Financial Services, Inc. (NBFS), which offers investment and insurance products. Revenues and net income derived from the nonbanking affiliate are not significant at this time, nor are they expected to be significant in the foreseeable future.

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Performance Summary

The following table shows NBI's key performance ratios for the period ended December 31, 2005 and 2004:

| | 12/31/05 | 12/31/04 |
|--------------------------------------|----------|----------|
| Return on average assets | 1.52% | 1.62% |
| Return on average equity | 13.73% | 14.48% |
| Basic net earnings per share | \$ 3.54 | \$ 3.48 |
| Fully diluted net earnings per share | \$ 3.52 | \$ 3.46 |
| Net interest margin (1) | 4.45% | 4.69% |
| Noninterest margin (2) | 1.74% | 1.77% |

- (1) Net Interest Margin - Year-to-date tax equivalent net interest income divided by year-to-date average earning assets.
- (2) Noninterest Margin - Noninterest income (excluding securities gain and losses) less noninterest expense (excluding the provision for bad debts and income taxes) divided by average year-to-date assets.

As can be seen from the above data, the Company's performance remains satisfactory though below 2004 levels. While the return on average assets and equity experienced slight declines, basic earnings per share increased by \$0.06. Return on average assets declined slightly because total assets in 2005 grew (from acquisitions and internally generated growth) at a faster rate than net earnings. Return on average equity was down from 2004 because the Company's equity, generally from retained earnings, increased at a faster rate than the current year's net earnings. Basic income per share increased by \$0.06 because net earnings were higher than in 2004 and the number of shares of stock outstanding was slightly less than last year.

The net interest margin for 2005 was 4.44%, which compares to 4.69% for 2004. The decline experienced in 2005 was almost exclusively due to an increase in funding costs.

The noninterest margin declined by 3 basis points.

Growth

The following table shows NBI's key growth indicators:

| | For the period ending | |
|--------------|-----------------------|-----------|
| | 12/31/05 | 12/31/04 |
| Securities | \$272,541 | \$250,708 |
| Loans, net | 487,162 | 472,199 |
| Deposits | 745,649 | 705,932 |
| Total assets | 841,498 | 796,154 |

Total assets at December 31, 2005 were \$841,498, an increase of \$45,344 or 5.70%. Loans net of unearned income and deferred fees increased \$14,963 or

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3.17%. Total deposits at period end were \$745,649, an increase of \$39,717 or 5.63%.

The above data reflects approximately \$8,831 in loans and approximately \$22,009 in deposits related to the acquisition of two branch facilities in the first quarter of 2005.

Asset Quality

Key asset quality indicators are shown below:

| | 12/31/05 | 12/31/04 |
|------------------------------------|----------|----------|
| Nonperforming loans | \$ 178 | \$ 394 |
| Loans past due over 90 days | 546 | 754 |
| Other real estate owned | 376 | 895 |
| Allowance for loan losses to loans | 1.11% | 1.20% |
| Net charge-off ratio | .17% | .30% |

15

Asset quality remains satisfactory as shown by the above data. Other real estate owned, in particular, has declined substantially.

The provision for loan losses for 2005 was \$567, as compared with \$1,189 in 2004. The ratio of the allowance for loan losses to loans was 1.11% at December 31, 2005 and 1.20% at December 31, 2004. The decline in the provision and the related decline in the ratios of the allowance for loan losses to loans were justified by the improved quality of the subsidiary bank loan portfolios.

Net Interest Income

2005 vs 2004

Net interest income for the period ended December 31, 2005, was \$31,200, an increase of \$833 or 2.74% over 2004. A larger volume of loans was the primary source of the increase in interest income, and rising interest rates resulted in higher interest expense. This is illustrated in the table, "Analysis of Changes in Interest Income and Expense", and is also shown by an examination of the various components of the net interest margin.

The first component of net interest income, the yield of earning assets, was at 6.29% in 2005, a 3 basis point increase over 2004. Since the yield on earning assets was largely unchanged between 2004 and 2005, it follows that most of the \$3,888 increase in interest income came from a higher volume of interest earning assets, particularly in the loan category. The second component of net interest income is the cost to fund earning assets. The cost to fund earning assets increased from 1.94% in 2004 to 2.32% in 2005. Approximately \$2,287 of the \$3,055 increase was the result of higher interest rates. The net effect of these factors was a 24 basis point decline in the net interest margin.

Management anticipates that funding costs will continue to rise in 2006. First, it is expected that the Federal Reserve Bank will continue its current pattern of regular interest rate increases into the first half of 2006. The Federal Reserve Bank has articulated a policy of increasing interest rates to a level that neither stimulates nor inhibits the economy. Should economic factors such as rising oil prices result in higher inflation, management believes that the Federal Reserve Bank would respond with additional increases. In management's opinion, prospects of higher inflation are uncertain and any increases in interest rates would, in the intermediate term, have a negative effect on the Company's net interest income.

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In addition, management believes a second factor will very likely cause funding costs to rise during 2006. As time deposits mature, they will be reinvested at a higher rate of interest. Therefore, for some period of time after the Federal Reserve Bank stabilizes interest rates, the Company's interest expenses will be expected to increase.

2004 vs 2003

Net interest income for the period ended December 31, 2004 was \$30,367, an increase of \$1,538 or 5.33% over 2003. The net interest margin was 4.69% for the period ended December 31, 2004 and 4.82% for the period ended December 31, 2003.

During the past two years the Company has benefited from a relatively long period of low interest rates, which has no recent precedent. The trend continued into the first half of 2004. In June of 2004, the Federal Reserve Board raised the federal funds rate 25 basis points, signaling the start of a higher interest rate environment. Since then additional rate increases have occurred, with more expected. Many forecasters agree that interest rates will trend upward in small increments. However, the impact of other events, such as, but not limited to, oil prices, problems in the Middle East and terrorist related activities, could negatively impact the national economy and alter plans for future interest rate increases. If such events were to occur, the Company, together with the entire banking industry, could be affected to some extent.

The general impact of a rising interest rate scenario on the Company's balance sheet follows.

Federal Funds Sold and Interest-bearing Deposits - These are overnight funds used primarily for liquidity purposes. They mature daily and, accordingly, interest rates change daily, which is advantageous in a period of rising interest rates. However these funds yield low interest, making other investments more attractive from an earnings standpoint.

Securities Available for Sale - This category provides a higher level of earnings than overnight funds. It can, under certain circumstances, be a source of liquidity, and it also demonstrates the ability to re-price. While these securities can be sold to provide liquidity and for interest rate sensitivity purposes, temporary declines in fair market value due to rising interest rates may make it unprofitable to sell the securities. In addition, embedded call features may not be activated during periods of high rates, leaving the Company with a "hold" or "sell" decision.

Securities Held to Maturity - Because of its nature, this category of investments is not structured to be a source of liquidity or to moderate interest rate sensitivity. These securities must be held to maturity except under extenuating circumstances. In a rising rate environment, the difference in the amount of interest income earned and the cost to fund the securities decreases. In other words, net interest income from these investments declines. Embedded call features may not be activated during periods of high rates.

Mortgage Loans Held for Sale - This category is primarily driven by volume. In periods of low interest rates, mortgage refinancing activity and home sales

16

tend to accelerate and generate higher revenue levels than are experienced in times of high interest rates. In the last two years, re-financing activity has been significant. Recently, however, despite the continuing low rate environment, activity has declined.

Loans - While the low rate environment of the recent past is more conducive to loan production than periods of high interest rates, interest rates that are unusually low are a sign of a weak or a recovering economy. Ideal volumes may in

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fact be achieved in a more robust economy in which more moderate rate levels exist. If the economy continues to recover as forecast, higher loan volumes would have a positive impact on net interest income.

Of particular concern is the area of loans to individuals, which has been in a downward trend for several quarters, with the only growth coming from loans acquired in purchase and assumption transactions. Management believes the decline is due to several reasons.

- o General economic conditions and the lack of employment in portions of the Company's market area.
- o A decline in consumer requests for new car financing because of special incentives offered by automobile companies.
- o Consumers' use of credit cards and home equity lines with higher credit limits.
- o Consumers taking advantage of low mortgage rates to refinance home mortgages to obtain funds that might otherwise have been borrowed through a consumer loan.

A reversal of this trend may occur to some extent as economic conditions change and higher interest rates make mortgage refinancing less appealing. However, management believes that the automotive related financing offers and competition from the credit card sector will remain. Since loans to individuals are generally higher yielding, this trend will not have a favorable effect on net interest income.

Deposit Expense

2005 vs 2004

As previously noted in the discussion of net interest income, funding costs are expected to rise in 2006. See the discussion of "Net Interest Income" for further comments.

2004 vs 2003

During periods of rising interest rates, interest-bearing demand deposits, and to a lesser degree savings deposits, migrate to higher rate, longer-term time deposits. Generally, as rates climb, more migration occurs. Given their re-pricing characteristics, interest-bearing demand deposits readily respond to any interest rate movement. In other words, increases or decreases in interest expense can occur quite quickly.

With a definite bias towards higher interest rates in the future, it is expected that the net interest margin will decline, at least temporarily, in response to rising interest rates. As previously stated, the ultimate impact of rising interest rates is dependent upon the number of rate increases, the amount of the increases and the level to which interest rates ultimately rise.

17

Analysis of Net Interest Earnings

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the interest earned or paid, the average yield or rate on the daily average balance outstanding, net interest income and net yield on average interest-earning assets for the years indicated.

| | December 31, 2005 | | | December 31, 2004 | | |
|-------------------|--------------------|----------|---------------------------|--------------------|----------|---------------------------|
| (\$ in thousands) | Average Balance | Interest | Average Yield/ Rate | Average Balance | Interest | Average Yield/ Rate |
| | | | | | | |

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Interest-earning
assets:

| | | | | | | | |
|-------------------------------|------------|----------|-------|------------|----------|-------|----|
| Loans, net (1) (2) (3) | \$ 492,760 | \$33,400 | 6.78% | \$ 444,984 | \$29,898 | 6.72% | \$ |
| Taxable securities | 135,347 | 6,501 | 4.80% | 121,770 | 6,184 | 5.08% | |
| Nontaxable securities (1) (4) | 125,683 | 7,960 | 6.33% | 126,365 | 8,146 | 6.45% | |
| Federal funds sold | --- | --- | --- | 276 | 5 | 1.81% | |
| Interest bearing deposits | 14,819 | 508 | 3.43% | 16,224 | 196 | 1.21% | |
| ----- | | | | | | | |
| Total interest-earning assets | \$ 768,609 | \$48,369 | 6.29% | \$709,619 | \$44,429 | 6.26% | \$ |
| ===== | | | | | | | |

Interest-bearing
liabilities:

| | | | | | | | |
|------------------------------------|-----------|----------|-------|-----------|----------|-------|----|
| Interest-bearing demand deposits | \$204,522 | \$ 2,675 | 1.31% | \$186,106 | \$ 1,556 | 0.84% | \$ |
| Savings deposits | 57,836 | 261 | 0.45% | 58,899 | 255 | 0.43% | |
| Time deposits | 347,471 | 11,221 | 3.23% | 327,302 | 9,300 | 2.84% | |
| Short-term borrowings | 705 | 23 | 3.26% | 531 | 14 | 2.64% | |
| ----- | | | | | | | |
| Total interest-bearing liabilities | \$610,534 | \$14,180 | 2.32% | \$572,838 | \$11,125 | 1.94% | \$ |
| ===== | | | | | | | |

| | | | | | | | |
|--|--|----------|-------|--|----------|-------|--|
| Net interest income and interest rate spread | | \$34,189 | 3.97% | | \$33,304 | 4.32% | |
| ===== | | | | | | | |

| | | | | | | | |
|--|--|--|-------|--|--|-------|--|
| Net yield on average interest-earning assets | | | 4.45% | | | 4.69% | |
| ===== | | | | | | | |

- (1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three years presented.
- (2) Loan fees of \$650 in 2005, \$473 in 2004 and \$716 in 2003 are included in total interest income. (3) Nonaccrual loans are included in average balances for yield computations. (4) Daily averages are shown at amortized cost.

Analysis of Changes in Interest Income and Interest Expense

The Company's primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other funds. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate).

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| (\$ in thousands) | 2005 Over 2004 | | | Changes D |
|--|----------------|------------|-------------------|------------|
| | Changes Due To | | | |
| | Rates (2) | Volume (2) | Net Dollar Change | Rates (2) |
| Interest income:(1) | | | | |
| Loans | \$266 | \$3,236 | \$3,502 | \$ (2,301) |
| Taxable securities | (347) | 664 | 317 | (550) |
| Nontaxable securities | (142) | (44) | (186) | (254) |
| Federal funds sold | --- | (5) | (5) | 6 |
| Interest-bearing deposits | 330 | (18) | 312 | 32 |
| ----- | | | | |
| Increase(decrease) in income on interest-earning assets | \$107 | \$3,833 | \$3,940 | \$ (3,067) |
| ----- | | | | |
| Interest expense: | | | | |
| Interest-bearing demand deposits | \$952 | \$167 | \$1,119 | \$ (181) |
| Savings deposits | 11 | (5) | 6 | (109) |
| Time deposits | 1,324 | 597 | 1,921 | (1,352) |
| Short-term borrowings | --- | 9 | 9 | 6 |
| Long-Term Borrowings | --- | --- | --- | --- |
| ----- | | | | |
| Increase (decrease) in expense of interest-bearing liabilities | \$2,287 | \$768 | \$3,055 | \$ (1,636) |
| ----- | | | | |
| Increase (decrease) in net interest income | \$ (2,180) | \$3,065 | \$889 | \$ (1,431) |

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2005, 2004 and 2003. (2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

Interest Rate Sensitivity

2005 vs 2004

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Interest rate sensitivity analyses provides management with information related to repricing opportunities, while interest rate shock simulations indicate potential economic loss due to future interest rate changes. Risk factors and forward-looking statements previously discussed under "Net Interest Income" apply. As previously stated, the Company uses simulation analysis to forecast its balance sheet and monitor interest rate sensitivity. One test is a shock analysis that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on net income and return

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on average assets and return on average equity projected at December 31, 2005.

For purposes of this analysis noninterest income and expenses are assumed to be flat.

(\$ in thousands, except for percent data)

| Rate Shift (bp) | Return on Average Assets | Return on Average Equity |
|-----------------|--------------------------|--------------------------|
| 300 | 1.45% | 13.21% |
| 200 | 1.55% | 14.11% |
| 100 | 1.65% | 15.01% |
| (-)100 | 1.79% | 16.32% |
| (-)200 | 1.81% | 16.48% |
| (-)300 | 1.80% | 16.42% |

Simulation analysis allows the Company to test asset and liability management strategies under rising and falling rate conditions. As a part of the simulation process, certain estimates and assumptions must be made. These include, but are not limited to, asset growth, the mix of assets and liabilities, rate environment and local and national economic conditions. Asset growth and the mix of assets can, to a degree, be influenced by management. Other areas, such as the rate environment and economic factors, cannot be controlled. For this reason actual results may vary materially from any particular forecast or shock analysis.

This shortcoming is offset somewhat by the periodic reforecasting of the balance sheet to reflect current trends and economic conditions. Shock analysis must also be updated periodically as a part of the asset and liability management process.

2004 vs 2003

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Interest rate sensitivity analyses provides management with information related to repricing opportunities, while interest rate shock simulations indicate potential economic loss due to future interest rate changes. Risk factors and forward-looking statements previously discussed under "Net Interest Income" apply. As previously stated, the Company uses simulation analysis to forecast its balance sheet and monitor interest rate sensitivity. One test is a shock analysis that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on net income and return on average assets and return on average equity projected at December 31, 2004.

For purposes of this analysis noninterest income and expenses are assumed to be flat.

(\$ in thousands, except for percent data)

| Rate Shift (bp) | Return on Average Assets | Return on Average Equity |
|-----------------|--------------------------|--------------------------|
| 300 | 1.20% | 10.45% |

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| | | |
|---------|-------|--------|
| 200 | 1.49% | 12.80% |
| 100 | 1.75% | 14.95% |
| (-) 100 | 2.21% | 18.54% |
| (-) 200 | 2.17% | 18.27% |
| (-) 300 | 2.08% | 17.53% |

20

Noninterest Income

2005 vs 2004

| | December 31, 2005 | December 31, 2004 | December |
|----------------------------------|-------------------|-------------------|----------|
| Service charges on deposits | \$3,099 | \$3,003 | \$ |
| Other service charges and fees | 298 | 252 | |
| Credit card fees | 2,179 | 1,839 | |
| Trust fees | 1,398 | 1,436 | |
| Other income | 639 | 444 | |
| Realized securities gains/losses | --- | 168 | |
| | --- | --- | |
| Total noninterest income | \$7,613 | \$7,142 | \$ |
| | ===== | ===== | = |

Service charges on deposits for the year ended December 31, 2005 were \$3,099, an increase of \$96 or 3.20%. Several types of charges imposed on demand deposit accounts, interest-bearing deposit accounts and savings deposit accounts are included in this category, such as monthly fees on demand deposit accounts, charges for overdrafts and returned checks and ATM fees. The level of these types of charges can be affected by internal growth, acquisitions and by changes in fee schedules. The modest increase in 2005 was the result of both internal growth and the acquisition of two branches, with approximately \$42 being attributable to acquisitions and the balance attributable to internal growth. There were no significant changes to the structure of service charges during the year.

Other service charges and fees were \$298 for the period ended December 31, 2005. This represents an increase of \$46 or 18.25% over the previous year. Included in this category are a variety of fees, such as fees for the issuance of official checks, safe deposit box rent, income from the sale of checks to customers and commissions earned on the sale of credit life, accident and health insurance. The level of income derived from these various types of fees varies. Fees for official checks and income from the sale of customer checks grow as new offices and new customers are added. The most significant increases in safe deposit box rent also come with new offices. Changes in fee schedules generally do not have a discernable impact on the level of fees. Income derived from the sale of credit life, accident and health insurance varies with loan volume. In 2005, \$13 of the \$46 increase in other service charges and fees was attributable to commissions from the sale of credit life, accident and health insurance.

Credit card fees for the period ended December 31, 2005 were \$2,179, an increase of \$340 or 18.49% over the previous year. Credit card transaction fees, debit card transaction fees and merchant fees are included in this category.

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Growth in the number of credit and debit card accounts results in higher fee income. Merchant fees also depend on the number of businesses using the Company's program, as well as the type of business and level of transactions. Internal growth caused the increase in 2005 credit card fee income.

For the year ended December 31, 2005, trust income was \$1,398, as compared with \$1,436 in 2004. Trust income is generated by a number of sources, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income is dependent upon market conditions and the number and type of accounts being managed. Trust account values are affected by financial market conditions and this leads to fluctuations in trust income. For 2005, trust income declined by \$38 when compared with 2004. Income from estates was off by \$63 from 2004, and income from attorney-in-fact accounts declined by \$40. There was an increase of \$27 in custodial account income, and income from other types of accounts grew by \$38 when compared with 2004.

Other types of income that cannot be included in the categories listed above is classified as other income. Examples are net gains on the sale of fixed assets, rent on foreclosed properties, income from increases in the cash value of life insurance and revenue from the sale of investments and insurance. When 2005 and 2004 are compared, the other income category, which was \$639 at December 31, 2005, increased by \$195 or 43.92%. With increased investment and insurance sales, the Company's nonblank subsidiary, National Bankshares Financial Services, Inc., was responsible for \$171 of the \$195 increase in other income in 2005.

Realized gains of \$189 in securities matured or sold were totally offset by realized losses of an equal amount in 2005.

2004 vs 2003

Noninterest income is comprised of several categories. Following is a description of each, as well as the factors that influence each.

Service charges on deposit accounts consist of a variety of charges imposed on demand deposits, interest-bearing deposits and savings deposit accounts. These include, but are not limited to, the following:

- o Demand deposit monthly activity fees
- o Service charges for checks for which there are non-sufficient funds or overdraft charges
- o ATM transaction fees

21

The principal factors affecting current or future income are:

- o Internally generated growth
- o Acquisitions of other banks/branches or de novo branches
- o Adjustments to service charge structures

In 2003, the Company made certain changes to its service charge structure. These changes were not in effect in the first quarter of 2003. The remainder of the increase was due to volume, combined with routine charge-offs. Revenues are expected to continue to grow if, for no other reason, than the two recent acquisitions. See the comments under "Acquisitions."

Other service charges and fees consist of several categories. The primary categories are listed below.

- o Fees for the issuance of official checks
 - o Safe deposit box rent
 - o Income from the sale of customer checks
 - o Income from the sale of credit life and accident and health insurance
- Levels of income derived from these categories vary. Fees for the issuance

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of official checks and customer check sales tend to grow as the existing franchise grows and as new offices are added. Fee schedules, while subject to change, generally do not alone yield a significant or discernable increase in income when adjusted. The most significant growth in safe deposit box rent also comes with an expansion of offices. Safe deposit box fee schedules, which are already at competitive levels, are occasionally adjusted. Income derived from the sale of credit life insurance and accident and health insurance varies with loan volumes.

Credit card fees consist of three types of revenues as follows:

- o Credit card transaction fees
- o Debit card transaction fees
- o Merchant fees

In all three cases, volume is critical to growth in income. For debit and credit cards the number of accounts, whether obtained from internal growth or by acquisition, is the key factor. Merchant fees also depend on the number of merchants in the Company's program, as well as the type of business and the level of transaction discounts associated with them.

Trust income is somewhat dependent upon market conditions and the number of estate accounts being handled at any given point in time. Financial market conditions, which affect the value of trust assets managed, can vary, leading to fluctuations in the related income. Over the past few years and into 2004, the financial markets have experienced a significant degree of volatility.

Of the \$304 increase, approximately \$254 was attributable to income from the settlement of estates. Improvement in market conditions accounts for the majority of the remaining increase.

The other income category is used for types of income that cannot be classified with other forms of noninterest income. The category includes such things as:

- o Net gains on the sale of fixed assets
- o Rent on foreclosed property
- o Income from cash value life insurance
- o Other infrequent or minor forms of income
- o Revenue from investment and insurance sales

Given the nature of the items included in this category, it is difficult to determine trends or patterns. Items warranting discussion are usually non-recurring in nature.

Net realized gains on securities at December 31, 2004 were \$168 and were the results of called or sold securities, offset by write downs in certain equity securities.

Noninterest Expense

2005 vs 2004

| | December 31, 2005 | December 31, 2004 | December |
|---------------------------------------|-------------------|-------------------|----------|
| Salaries and employee benefits | \$11,265 | \$10,498 | \$9 |
| Occupancy and furniture and fixtures | 1,931 | 1,797 | 1 |
| Data processing and ATM | 1,455 | 1,302 | 1 |
| Credit card processing | 1,687 | 1,502 | 1 |
| Intangibles and goodwill amortization | 1,117 | 967 | |
| Net costs of other real estate owned | 275 | 201 | |
| Other operating expenses | 4,168 | 4,069 | 3 |
| | ----- | ----- | - |
| | \$21,898 | \$20,336 | \$18 |

From December 31, 2004 to December 31, 2005, salary and benefits expense increased by \$767 or 7.31% to \$11,265. Approximately \$255 of the year-over-year increase was attributable to the addition of a number of employees from acquisitions in mid-2004 and early 2005. Higher pension costs accounted for \$118 of the increase, and health insurance premiums added \$61 to the category. Routine merit salary increases averaging 3% accounted for the remainder of the growth in salary and benefits expense.

Occupancy and furniture and fixtures expense was \$1,931 for the period ended December 31, 2005. This represents an increase of \$134 or 7.46%. Occupancy expense includes items such as depreciation expense, maintenance and repairs and real estate taxes. This category of expense can be affected by acquiring new property as a result of the construction of new offices and additions to existing offices or through merger or purchases of banks or single or multiple office locations. Conversely, occupancy and furniture and fixture expense can decline with the consolidation, closure or sale of branch offices. For 2005, the costs for the installation of a new Company-wide telephone system and for fixed assets purchased in the 2005 branch office acquisition contributed to the year over year increase.

For 2005, data processing and ATM expense grew by \$153 or 11.75% over 2004. Included in the 2005 total was approximately \$152 in expenses attributable to the first quarter conversion of the computer system of Community National Bank, acquired in 2004. Servicing fees to Community National Bank's data processor were approximately \$47 to the point of conversion.

Credit card processing expense was \$1,687 for the period ended December 31, 2005, an increase of \$185 or 12.32% over 2004. These expenses are volume driven and are directly related to the level of credit card fees. Comments in that section of the discussion of Noninterest Income apply.

There was an increase of \$150 or 15.51% in intangible and goodwill expense when 2005 and 2004 are compared, with a total of \$1,117 for 2005. This category of noninterest expense is related to acquisitions, and, as noted above, the Company acquired two branch offices in early 2005. In addition, expenses associated with the 2004 branch office and bank acquisitions, which occurred at different times during 2004, did not impact intangible and goodwill expense for the full calendar year, but they were included for the entire year in 2005.

Net costs of other real estate owned were \$275 for 2005, an increase of \$74 when compared with 2004. These costs are related to the write-down and liquidation of foreclosed properties. This year's expenses are higher than in 2004 because of the disposition of a greater number of foreclosed properties. There has been an improvement in the amount of foreclosed property during 2005, and the table which follows under "Risk Elements" illustrates this.

Other operating costs for the period ended December 31, 2005 were \$4,168, up by \$99 or 2.43% over the same period in 2004. The 2005 increase was nominal. Franchise taxes, stationery and supplies, telephone costs, postage and charitable donations are examples of other operating costs.

2004 vs 2003

Noninterest expense includes several categories. Following is a brief description of the factors that affect each.

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In addition to employee salaries, the salaries and benefits expense category includes the costs of employment taxes and employee fringe benefits. Certain of these are:

- o Health insurance
- o Employee life insurance
- o Dental insurance
- o Executive compensation plans (1)
- o Pension plans (1)
- o Employee stock option plan (1)
- o Employer FICA
- o Unemployment taxes

(1) See the Proxy Statement for the 2005 Annual Stockholders meeting for further information. For 2004, salary and benefits expense was up \$930 or 9.72%.

Routine salary increases and health insurance cost increases contributed to the increase.

Of more significance were the purchase and assumption transactions. While the FNB-SE branch acquisition added no employees to the payroll, the CNB purchase and assumption initially added twenty-one employees. Because the Company's NBB subsidiary is operating the former CNB office as a branch office, many former CNB employees were retained in their previous positions. Some former CNB employees hold jobs that are performed elsewhere at NBB and they have moved to those positions as the need arose.

Occupancy costs include such items as depreciation expense, maintenance of the properties, repairs and real estate taxes. This category is most affected by

23

new property acquisitions resulting from mergers, branch purchases or construction of new branch facilities. Conversely, expense can be lowered by branch office consolidations or closures, which though infrequent, have occurred. On occasion, repairs and other expense items can rise to significant levels, though not frequently. This category increased \$142 when 2004 and 2003 are compared. New branches, renovation and acquisitions also create increases in the area.

The Company maintains its own data processing facility and has ATM's at twenty-four subsidiary bank offices and other locations. Costs to operate these are reflected in this category and include depreciation, maintenance, communication lines and certain supplies.

Data processing costs were up \$138 when 2004 is compared to 2003. While these cost increases are nominal, larger increases are expected because of the completion of the two previously mentioned purchase and assumption transactions. The first purchase and assumption transaction was quite small and has not greatly impacted data processing and ATM expense. The second acquisition involved the assets and liabilities of an existing bank, including assumption of its existing data processing contract, which will remain until mid 2005. Assumption of this contract increased monthly costs by approximately \$12-\$15. While the contract terminates in mid 2005, no substantial decreases in processing costs are expected, as the company's primary data processing contract allows for incremental increases. The Company also added three ATM's at its bank affiliates during 2004.

Credit card processing includes costs associated with the processing of credit cards, debit cards and merchant transactions. These expenses are related to credit card income previously discussed in the "Noninterest Income" section, and the comments in that section are applicable.

At December 31, 2004 the net costs of other real estate owned was \$201. Expense has risen steadily for the past three years. Other real estate owned at December 31, 2004 was \$895, which compares to \$1,663 at December 31, 2003 and

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\$537 at December 31, 2002.

Other operating expenses include all other forms of expense not classified elsewhere in the Company's statement of income. Included in this category are such items as stationery and supplies, franchise taxes, contributions, telephone, postage and other operating costs. Many of the expenses included in this category are relatively stable or moderately increase with inflation from year to year. However, there are some items included in the category, such as other losses and charge-offs and repossession expense, which can vary from time to time. While many of the items in this category have identifiable trends, others may have frequent nonrecurring items or items that occur at no particular frequency. This category was also affected by the recent acquisitions. Categories such as stationery and supplies, telephone, and postage all increase when new offices are acquired.

Overall cost for this category increased 4.79%, when the periods ending December 31, 2004 and December 31, 2003 are compared.

Income Taxes

2005 vs 2004

Income tax expense for 2005 was \$3,924, an increase of \$170. Tax exempt income continues to be the primary difference between the expected and actual income tax expense. The Company's effective tax rates for 2005, 2004 and 2003 were 24.00%, 23.49% and 22.05%, respectively. The Company is subject to the 35% marginal tax rate.

2004 vs 2003

Income tax expense for 2004 increased by \$518 when compared to 2003.

Tax exempt income was the primary difference between the expected and reported tax expense. The Company's effective tax rates for 2004, 2003 and 2002 were 23.49%, 22.05% and 23.07%, respectively. The Company is subject to the 35% marginal tax rate.

See Note 10 of the Notes to Consolidated Financial Statements for additional information relating to income taxes.

Effects of Inflation

The Company's consolidated statements of income generally reflect the effects of inflation. Since interest rates, loan demand, and deposit levels are related to inflation, the resulting changes are included in net income. The most significant item which does not reflect the effects of inflation is depreciation expense. Historical dollar values used to determine depreciation expense do not reflect the effects of inflation on the market value of depreciable assets after their acquisition.

Provision and Allowance for Loan Losses

2005 vs 2004

The allowance for loan losses at December 31, 2005 was \$5,449, a \$280 decrease from the same period ended December 31, 2004. The ratio of the allowance for loan losses to total loans at the end of 2005 was 1.11%, which compares to 1.20% last year. The net charge-off ratio at December 31, 2005 was 0.17%, and it was 0.30% at December 31, 2004.

The Company regularly reviews asset quality and re-evaluates the adequacy of the allowance for loan losses. Reviews are conducted of the status of the loan portfolios at each of the two bank subsidiaries, and an appropriate allowance for loan losses is established for each bank, depending upon factors that are unique to the bank and the quality of its loan portfolio. As noted above, the

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ratio of the allowance for loan losses to total loans is lower than at the end of 2004. The ratio has declined as total loans have grown from \$477,928 at December 31, 2004 to 492,611 at December 31, 2005, while the level of the allowance has remained relatively stable. Because of the continued excellent overall quality of the loan portfolio at one subsidiary bank and the improving quality of the loan portfolio at the second bank, it is management's judgment that the decrease in the provision for loan losses is justified and the allowance is appropriate and adequate. (See "Allowance for Loan Losses" under "Critical Accounting Policies".)

2004 vs 2003

The adequacy of the allowance for loan losses is based on management's judgment and analysis of current and historical loss experience, risk characteristics of the loan portfolio, concentrations of credit and asset quality, as well as other internal and external factors, such as general economic conditions.

An internal credit review department performs pre-credit analyses of large credits and also conducts credit review activities that provide management with an early warning of asset quality deterioration.

The internal credit review department also prepares regular analyses of the adequacy of the provision for loans losses. These analyses include calculations based upon a mathematical formula that considers identified potential losses and makes pool allocations for historical losses for various loan types. In addition, an amount is allocated based upon such factors as changing trends in the loan mix, the effects of changes in business conditions, the effects of any changes in loan policies, and the effects of competition and regulatory factors on the loan portfolio. The internal credit review department has determined that the Company's provision for loan losses is sufficient.

Overall asset quality has improved in 2004. Reference is made to data shown in the performance summary.

25

IV. Summary of Loan Loss Experience

A. Analysis of the Allowance for Loan Losses

The following tabulation shows average loan balances at the end of each period; changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category; and additions to the allowance which have been charged to operating expense:

| (\$ in thousands) | December 31, | | |
|---------------------------------|--------------|-----------|-----------|
| | 2005 | 2004 | 2003 |
| Average net loans outstanding | \$487,130 | \$438,761 | \$405,696 |
| Balance at beginning of year | \$ 5,729 | \$ 5,369 | \$ 5,092 |
| Charge-offs: | | | |
| Commercial and industrial loans | 373 | 533 | 241 |
| Real estate mortgage loans | 50 | 120 | 299 |
| Real estate construction loans | --- | 24 | --- |
| Loans to individuals | 678 | 873 | 1,120 |
| Total loans charged off | 1,101 | 1,550 | 1,660 |

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| | | | |
|--|----------|----------|----------|
| Recoveries: | | | |
| Commercial and industrial loans | 55 | 46 | 104 |
| Real estate mortgage loans | 35 | 31 | --- |
| Real estate construction loans | --- | --- | --- |
| Loans to individuals | 164 | 146 | 142 |
| Total recoveries | 254 | 223 | 246 |
| Net loans charged off | 847 | 1,327 | 1,414 |
| Additions charged to operations | 567 | 1,189 | 1,691 |
| Acquisition of CNB | --- | 498 | --- |
| Balance at end of year | \$ 5,449 | \$ 5,729 | \$ 5,369 |
| Net charge-offs to average net loans outstanding | 0.17% | 0.30% | 0.34% |

Factors influencing management's judgment in determining the amount of the loan loss provision charged to operating expense include the quality of the loan portfolio as determined by management, the historical loan loss experience, diversification as to type of loans in the portfolio, the amount of secured as compared with unsecured loans and the value of underlying collateral, banking industry standards and averages, and general economic conditions.

26

B. Allocation of the Allowance for Loan Losses

The allowance for loan losses has been allocated according to the amount deemed necessary to provide for anticipated losses within the categories of loans for the years indicated as follows:

| | December 31, | | | | | | |
|---------------------------------|------------------|--|------------------|--|------------------|--|------------------|
| | 2005 | | 2004 | | 2003 | | 2002 |
| (\$ in thousands) | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount |
| Commercial and industrial loans | \$1,478 | 53.52% | \$1,387 | 51.90% | \$1,239 | 51.26% | \$235 |
| Real estate mortgage loans | 1,212 | 23.79% | 990 | 24.10% | 970 | 21.56% | 911 |
| Real estate | | | | | | | |

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| | | | | | | | |
|----------------------|---------|---------|---------|---------|---------|---------|---------|
| construction loans | 420 | 5.50% | 359 | 5.22% | 125 | 6.88% | --- |
| Loans to individuals | 2,190 | 17.19% | 2,016 | 18.78% | 2,257 | 20.30% | 3,092 |
| Unallocated | 149 | | 977 | | 778 | | 854 |
| | \$5,449 | 100.00% | \$5,729 | 100.00% | \$5,369 | 100.00% | \$5,092 |

27

Balance Sheet

2005 vs 2004

Total assets at December 31, 2005 were \$841,498, an increase of \$45,344 or 5.70% over the previous year. Acquisitions accounted for approximately \$22 million of the total growth in total assets. In February 2005, BTC acquired two branches from Planters Bank and Trust Company of Virginia. This acquisition added approximately \$22 million in deposits.

2004 vs 2003

Total assets for Company at December 31, 2004 were \$796,154, an increase of \$87,594, or 12.36%, over December 31, 2003. The two acquisitions described in the performance summary account for much of the growth.

Loans

2005 vs 2004

The mix of loan categories at December 31, 2005 and December 31, 2004 is shown in the following table.

| | December 31, 2005 | December 31, 2004 |
|---------------------------------|-------------------|-------------------|
| Real estate construction loans | \$ 27,116 | \$ 25,009 |
| Real estate mortgage loans | 117,421 | 115,388 |
| Commercial and industrial loans | 264,149 | 248,523 |
| Loans to individuals | 84,838 | 89,889 |
| | ----- | ----- |
| Total loans | \$ 493,524 | \$ 478,809 |
| | ===== | ===== |

The table illustrates that the highest level of growth in 2005 occurred in commercial and industrial loans. Real estate construction loans and real estate mortgage loans grew at a more modest rate. Loans to individuals dropped slightly. Future declines are expected in loans to individuals, as past growth in this category was driven by acquisitions. In addition, competition and other factors, including consumer use of credit cards, home equity lines and special automobile financing, make internally generated growth of consumer loans quite challenging. Acquisitions accounted for approximately \$8.8 million of the overall loan growth.

2004 vs 2003

The mix of loan categories at December 31, 2004 and December 31, 2003 is shown in the following table.

| | December 31, 2004 | December 31, 2003 |
|------------------------------------|-------------------|-------------------|
| Real estate construction loans (1) | \$ 25,009 | \$ 28,055 |
| Real estate loans | 115,388 | 87,899 |

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| | | |
|---------------------------------|------------|------------|
| Commercial and industrial loans | 248,523 | 208,997 |
| Loans to individuals | 89,889 | 82,742 |
| | ----- | ----- |
| Total loans | \$ 478,809 | \$ 407,693 |
| | ===== | ===== |

(1) All categories shown reflect gross loans at period-end.

The volume of mortgage loans held for sale is directly related to interest rate levels. Activity generally peaks during periods of low interest rates, declining as interest rates rise. Period-end balances are not indicative of volume, as loans are constantly being originated and sold. The balance shown at period-end reflects only loans held by NBB for which there are purchase commitments from investors, but which have not yet been funded. At December 31, 2004 there were approximately \$3,611 in commitments to extend mortgage loans outstanding and \$1,717 at December 31, 2003.

Construction loans were \$25,009 at December 31, 2004 and \$28,055 at December 31, 2003, a decrease of \$3,046. This category tends to fluctuate because of demand. Demand may vary due to economic conditions and seasons. Completion of construction projects generally occurs within one year, at which time permanent financing through one of the Company's banking affiliates or another lender is obtained. Loans for which the Company retains permanent financing move into the commercial and industrial loan or mortgage loan categories.

Real estate loans at December 31, 2004 were \$115,388, which represents an increase of \$27,489 from December 31, 2003. Loans in this category are for one-to-four family housing and are loans the banking affiliates elected to retain rather than sell on the secondary market. Of that increase, approximately \$13,000 was acquired from CNB and \$2,600 was acquired from FNB-SE.

Commercial and industrial loans were \$248,523 at December 31, 2004, which represents an increase of \$39,526 from December 31, 2003. Included in this category are loans for working capital, equipment, commercial real estate and other loans for legitimate business needs. The CNB transaction accounted for approximately \$14,000 of this growth, and the FNB-SE acquisition contributed \$2,400. Historically, growth in this category has been satisfactory, and based on present knowledge, no adverse trends are anticipated.

28

Loans to individuals increased by \$7,147 when December 31, 2004 is compared to December 31, 2003. Growth attributable to the CNB transaction was approximately \$5,300, and \$2,200 came from FNB-SE. Growth rates in this category have trended downward, with most growth being the result of acquisitions. See the comments under "Net Interest Income".

A. Types of Loans

| | December 31, | | | | |
|--|--------------|-----------|-----------|-----------|-----------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Commercial and industrial loans | \$264,149 | \$248,523 | \$208,997 | \$209,368 | \$189,764 |
| Real estate mortgage loans | 117,421 | 115,388 | 87,899 | 82,193 | 77,339 |
| Real estate construction loans | 27,116 | 25,009 | 28,055 | 22,294 | 19,573 |
| Loans to individuals | 84,838 | 89,889 | 82,742 | 96,762 | 113,413 |
| | ----- | | | | |
| Total loans | \$493,524 | \$478,809 | \$407,693 | \$410,617 | \$400,089 |
| Less unearned income and deferred fees | (913) | (881) | (896) | (1,278) | (1,775) |
| | ----- | | | | |
| Total loans, net of unearned income | \$492,611 | \$477,928 | \$406,797 | \$409,339 | \$398,314 |

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| | | | | | |
|---------------------------------|-----------|-----------|-----------|-----------|-----------|
| Less allowance for loans losses | (5,449) | (5,729) | (5,369) | (5,092) | (4,272) |
| Total loans, net | \$487,162 | \$472,199 | \$401,428 | \$404,247 | \$394,042 |

B. Maturities and Interest Rate Sensitivities

| | December 31, 2005 | | | |
|---|-------------------|----------------|----------|----------------|
| | <1 Year | 1 - 5 Years | 5 Years | After Total |
| Commercial and industrial | \$76,033 | \$150,631 | \$37,485 | \$264,149 |
| Real estate construction | 27,116 | --- | --- | 27,116 |
| | 103,149 | 150,631 | 37,485 | 291,265 |
| Less loans with predetermined interest rates | 34,486 | 21,383 | 27,897 | 83,766 |
| Loans with adjustable rates | \$68,663 | \$129,248 | \$9,588 | \$207,499 |

C. Risk Elements

Nonaccrual, Past Due and Restructured Loans

The following table presents aggregate amounts for nonaccrual loans, restructured loans, other real estate owned net, and accruing loans which are contractually past due ninety days or more as to interest or principal payments.

| | December 31, | | | | |
|--|--------------|---------|---------|-------|------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Nonaccrual loans: | | | | | |
| Commercial and industrial | \$171 | \$354 | \$302 | \$102 | |
| Real estate mortgage | --- | 40 | 44 | 152 | |
| Loans to individuals | 7 | --- | 8 | 34 | |
| Total nonperforming loans | \$178 | \$394 | \$354 | \$288 | |
| Other real estate owned, net | 376 | 895 | 1,663 | 537 | |
| Total nonperforming assets | \$554 | \$1,289 | \$2,017 | \$825 | |
| Accruing loans past due 90 days or more: | | | | | |
| Commercial and industrial | \$142 | \$321 | \$98 | \$462 | |
| Real estate mortgage | 247 | 258 | 619 | 119 | |
| Loans to individuals | 157 | 175 | 214 | 396 | |
| | \$546 | \$754 | \$931 | \$977 | |

Loan loss and other industry indicators related to asset quality are presented in the Loan Loss Data table.

Loan Loss Data Table

| | 2005 | 2004 | 2003 |
|---|-----------|-----------|-----------|
| Provision for loan losses | \$ 567 | \$ 1,189 | \$ 1,189 |
| Net charge-offs to average net loans | 0.17% | 0.30% | 0.30% |
| Allowance for loan losses to loans, net of unearned income and deferred fees | 1.11% | 1.20% | 1.20% |
| Allowance for loan losses to nonperforming loans | 3,061.24% | 1,454.06% | 1,516.24% |
| Allowance for loan losses to nonperforming assets | 983.57 | 444.45% | 266.24% |
| Nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 0.11% | 0.27% | 0.27% |
| Nonaccrual loans | \$ 178 | \$ 394 | \$ 394 |
| Restructured loans | --- | --- | --- |
| Other real estate owned, net | \$ 376 | \$ 895 | \$ 895 |
| Total nonperforming assets | \$ 554 | \$ 1,289 | \$ 1,289 |
| Accruing loans past due 90 days or more | \$ 546 | \$ 754 | \$ 754 |

Note: Nonperforming loans include nonaccrual loans and restructured loans, but do not include accruing loans 90 days or more past due.

Securities

2005 vs 2004

Securities available for sale were \$162,833 at December 31, 2005 compared to \$145,323 at December 31, 2004. This represents an increase of \$17,510 or 12.05%. Securities held to maturity increased by \$4,323 in 2005. During 2005 the Company sold \$3,312 in securities held to maturity. Credit quality concerns prompted these sales.

2004 vs 2003

Securities available for sale increased by \$16,023 from December 31, 2003, while securities held to maturity increased by \$4,531. Of that increase, approximately \$9,519 was attributable to the CNB transaction. During 2004, \$1,310 in securities held to maturity were sold. Credit quality concerns prompted these sales.

Maturities and Associated Yields

The following table presents the maturities for securities available for sale and held to maturity at their carrying values as of December 31, 2005 and weighted average yield for each range of maturities.

=====

Maturities and Yields
December 31, 2005

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| (\$ in thousands except for % data) | <1 Year | 1-5 Years | 5-10 Years | > 10 Years |
|---|---------------------------|----------------------------|----------------------------|----------------------------|
| Available for Sale | | | | |
| U.S. Treasury | \$ 1,004 5.63% | \$ 946 2.65% | \$ 1,968 3.97% | \$ --- --- |
| U.S. Government agencies | --- | 18,630 4.64% | 3,886 4.48% | --- |
| Mortgage-backed securities | --- | 1,104 4.54% | 15,921 4.65% | 10,000 5.28% |
| States and political subdivision - taxable | --- | 102 5.88% | 3,534 5.24% | 41,966 7.96% |
| States and political subdivision - nontaxable(1) | 779 6.72% | 11,706 5.64% | 51,119 5.94% | 6,850 6.27% |
| Corporate | --- | 12,932 3.76% | 18,125 4.91% | --- |
| Federal Home Loan Bank stock | --- | --- | --- | --- |
| Federal Reserve Bank stock | --- | --- | --- | --- |
| Other securities | 455 3.83% | --- | --- | --- |
| Total | 2,238 5.64% | 45,420 4.61% | 94,553 5.40% | 17,270 5.74% |
| Held to Maturity | | | | |
| U.S. Treasury | --- | --- | --- | --- |
| U.S. Government agencies | --- | 17,626 4.51% | 10,977 4.48% | --- |
| Mortgage-backed securities | --- | 4 7.50% | 3 9.26% | 3,980 5.74% |
| States and political subdivision - taxable | --- | --- | 2,000 5.32% | --- |
| States and political subdivision - nontaxable (1) | --- | 14,269 6.05% | 34,286 6.14% | 6,340 5.70% |
| Corporate | 3,002 5.70% | 9,468 5.98% | 5,743 4.68% | 2,000 5.03% |
| Other securities | --- | --- | --- | --- |
| Total | \$ 3,002 5.70% | \$ 41,367 5.38% | \$ 53,009 5.61% | \$ 12,330 5.60% |

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(1) Rates shown represent weighted average yield on a fully taxable basis. The majority of mortgage-backed securities and collateralized mortgage obligations held at December 31, 2005 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Financial Institution Examination Council's (FFIEC) high risk mortgage security test. These tests address possible fluctuations in the average life and variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each. Except for U.S. Government securities, the Company has no securities with any issuer that exceeds 10% of stockholders' equity.

31

Deposits

2005 vs 2004

Total deposits at December 31, 2005 were \$745,649, an increase of \$39,717 or 5.63%. Of that increase approximately \$22 million came from first quarter acquisitions of two branch offices. Without the acquisition, deposit growth would have been approximately 2.50%. As shown in the balance sheet, time deposit and interest-bearing demand deposits experienced the highest levels of growth.

2004 vs 2003

Total deposits grew \$80,554 or 12.88% when December 31, 2004 and December 31, 2003 are compared. Of the nearly \$80,000 in growth, approximately \$60,000 was due to acquisitions.

The decline in time deposits was a continuation of the trend of customers being unwilling to choose longer term deposit instruments.

A. Average Amounts of Deposits and Average Rates Paid

Average amounts and average rates paid on deposit categories are presented below:

| (\$ in thousands) | December 31, | | | | | |
|-------------------------------------|--------------------|--------------------------|--------------------|--------------------|--------------------|--------------------------|
| | 2005 | | 2004 | | 2003 | |
| | Average Amounts | Average Rates Paid | Average Amounts | Average Amounts | Average Amounts | Average Rates Paid |
| Noninterest-bearing demand deposits | \$ 114,186 | --- | \$ 93,320 | --- | \$ 79,760 | |
| Interest-bearing demand deposits | 204,522 | 1.31% | 186,106 | 0.84% | 167,428 | 0. |
| Savings deposits | 57,836 | 0.45% | 58,899 | 0.43% | 51,646 | 0. |
| Time deposits | 347,471 | 3.23% | 327,302 | 2.84% | 317,989 | 3. |
| Average total deposits | \$724,015 | 2.32% | \$665,627 | 1.94% | \$616,823 | 2. |

B. Time Deposits of \$100,000 or More

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The following table sets forth time certificates of deposit and other time deposits of \$100,000 or more:

| | December 31, 2005 | | | | |
|--|---------------------|--------------------------------------|---------------------------------------|-------------------|-------|
| (\$ in thousands) | 3 Months or Less | Over 3 Months Through 6 Months | Over 6 Months Through 12 Months | Over 12 Months | Total |
| Total time deposits of \$100,000 or more | \$9,362 | \$20,182 | \$29,286 | \$56,139 | \$ |

Derivatives and Market Risk Exposures

The Company is not a party to derivative financial instruments with off-balance sheet risks such as futures, forwards, swaps, and options. The Company is a party to financial instruments with off-balance sheet risks such as commitments to extend credit, standby letters of credit, and recourse obligations in the normal course of business to meet the financing needs of its

32

customers. See Note 14, of Notes to Consolidated Financial Statements for additional information relating to financial instruments with off-balance sheet risk. Management does not plan any future involvement in high risk derivative products. The Company has investments in mortgage-backed securities, principally GNMA's and FNMA's, with a fair value of approximately \$31,040. The Company had no structured notes as of December 31, 2005. See Note 3, of Notes to Consolidated Financial Statements for additional information relating to securities.

The Company's securities and loans are subject to credit and interest rate risk, and its deposits are subject to interest rate risk. Management considers credit risk when a loan is granted and monitors credit risk after the loan is granted. The Company maintains an allowance for loan losses to absorb losses in the collection of its loans. See Note 5, of Notes to Consolidated Financial Statements for information relating to the allowance for loan losses. See Note 15, of Notes to Consolidated Financial Statements for information relating to concentrations of credit risk. The Company has an asset/liability program to manage its interest rate risk. This program provides management with information related to the rate sensitivity of certain assets and liabilities and the effect of changing rates on profitability and capital accounts.

The effects of changing interest rates are primarily managed through adjustments to the loan portfolio and deposit base, to the extent competitive factors allow. The investment portfolio is generally longer term. Adjustments for asset and liability management concerns are addressed when securities are called or mature and funds are subsequently reinvested. Historically, sales of securities have occurred for reasons related to credit quality or regulatory limitations. Few, if any, securities available for sale have been disposed of for the express purpose of managing interest rate risk.

No trading activity for this purpose is planned for the foreseeable future, though it does remain an option.

While this planning process is designed to protect the Company over the long-term, it does not provide near-term protection from interest rate shocks,

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as interest rate sensitive assets and liabilities do not, by their nature, move up or down in tandem in response to changes in the overall rate environment. The Company's profitability in the near term may be temporarily affected either positively by a falling interest rate scenario or negatively by a period of rising rates. See Note 16, of Notes to Consolidated Financial Statements for information relating to fair value of financial instruments and comments concerning interest rate sensitivity.

Liquidity

2005 vs 2004

Liquidity is the ability to provide sufficient cash flow to meet financial commitments and to fund additional loan demand or withdrawal of existing deposits. Sources of liquidity include deposits, loan principal and interest repayments, sales, calls and maturities of securities, and short-term borrowings. The Company also has available a line of credit with the Federal Home Loan Bank and may borrow from the Federal Reserve Bank discount window to provide for liquidity needs. The Company maintained an adequate liquidity level during 2005 and 2004.

Net cash provided by operating activities was \$15,461 for the period ended December 31, 2005, which compares to \$23,334 for the same period the previous year.

Net cash used in investing activities was \$20,036 for the period ended December 31, 2005, and \$38,762 used for the period ended December 31, 2004.

The Company obtained approximately \$13,178 in acquisitions in 2005, and used \$8,022 for acquisitions in 2004.

Net cash provided in financing activities was \$12,197 for the period ending December 31, 2005 and \$16,188 for the period ending December 31, 2004.

The Company has other available sources of liquidity. They include lines of credit with a correspondent bank, advances from the Federal Home Loan Bank, and Federal Reserve Bank discount window borrowings.

Management is unaware of any commitment that would have a material and adverse effect on liquidity at December 31, 2005. Total shareholders' equity grew by \$4,851 from December 31, 2004 to December 31, 2005. Earnings, net of the change in unrealized gains and losses for securities available for sale and dividends paid, accounted for most of the increase. Stock options exercised provided \$164. During 2005 the Company repurchased 15,940 shares of its common stock for \$744. The Tier I and Tier II risk-based capital ratios at December 31, 2005 were 13.1% and 14.1%, respectively.

2004 vs 2003

The Company maintained an adequate liquidity level during 2004 and 2003.

Net cash provided by operating activities was \$23,334 for the period ended December 31, 2004, which compares to \$14,793 for the same period the previous year.

Net cash used in investing activities was \$38,762 for the period ended December 31, 2004, and \$27,976 used for the period ended December 31, 2003.

The Company used approximately \$8,022 in acquisitions, and it had no acquisitions in 2003. Net cash provided in financing activities was \$16,188 for the period ending December 31, 2004 and \$12,600 for the period ending December 31, 2003. The substantial changes in cash used in investing activities and cash provided by financing activities are due to the CNB and FNB-SE transactions.

Included in the supplemental cash flow data is interest paid on deposits, which declined substantially when the periods December 31, 2004 and December 31,

2003 are compared. The decrease is due to a decline in interest expense due to the lower interest rate environment.

The Company has other available sources of liquidity. They include lines of

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credit with a correspondent bank, advances from the Federal Home Loan Bank, and Federal Reserve Bank discount window borrowings.

Total shareholders' equity grew by \$6,447 from December 31, 2003 to December 31, 2004. Earnings, net of the change in unrealized gains and losses for securities available for sale and dividends paid, accounted for most of the increase. Stock options exercised provided \$172. During the third quarter the Company repurchased 5,000 shares of the common stock for \$217. The Tier I and Tier II risk-based capital ratios at December 31, 2004 were 12.36% and 13.39%, respectively.

Recent Accounting Pronouncements

See Note 1, of Notes to Consolidated Financial Statements for information relating to recent accounting pronouncements.

Capital Resources

Total shareholders' equity at December 31, 2005 was \$91,939, an increase of \$4,851 or 5.57%. Total average capital to total average assets was 11.04% for 2005, which compares to 11.21% in 2004. Of the increase, net income accounted for \$12,424, offset by dividends to shareholders in the amount of \$4,991. Stock repurchased during the year cost \$744, while stock options exercised resulted in an addition to capital of \$164.

Off-Balance Sheet Arrangements

The Company's off-balance sheet arrangements are detailed in the table below.

| | Total | Payments Due by Period | | | More Than 5 Years |
|---|-------------------|------------------------|--------------|--------------|----------------------|
| | | Less Than 1 Year | 1-3 Years | 3-5 Years | |
| Commitments to extend credit | \$ 108,885 | 108,885 | --- | --- | --- |
| Standby letters of credit | 5,137 | 5,137 | --- | --- | --- |
| Mortgage loans with potential recourse | 17,915 | 17,915 | --- | --- | --- |
| Commitments to invest in LLC's | 885 | 885 | --- | --- | --- |
| Operating leases | 1,168 | 207 | 443 | 330 | 188 |
| Total | \$ 133,990 | 133,029 | 443 | 330 | 188 |

In the normal course of business the Company's banking affiliates extend lines of credit to their customers. Amounts drawn upon these lines vary at any given time depending on the business needs of the customers.

Standby letters of credit are also issued to the banks' customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation. Revenue from these letters was approximately \$15 in 2005.

While it would be possible for customers to draw in full on approved lines of credit and letters of credit, historically this has not occurred. In the event of a sudden and substantial draw on these lines, the Company has its own lines of credit on which it could draw funds. Sale of the loans would also be an option.

The Company also sells mortgages on the secondary market for which there are recourse agreements should the borrower default.

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Operating leases are for buildings used in the day-to-day operations of the Company.

During the fourth quarter of 2005 the Company announced that it would merge its BTC affiliate into its NBB affiliate. This merger is scheduled to occur in the second quarter of 2006. Management believes that greater operational efficiency will result from this merger.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Information about market risk is set forth above in the "Interest Rate Sensitivity" and "Derivatives and Market Risk Exposure" sections of the Management's Discussion and Analysis, which are in this report on pages 20 and 32, respectively.

34

Item 8. Financial Statements and Supplementary Data CONSOLIDATED BALANCE SHEETS

\$ In thousands, except share data.

December
2005

| <hr style="border-top: 1px dashed black;"/> | | | | |
|---|---|------------|--|------|
| Assets | Cash and due from banks | \$ 20,115 | | |
| | Interest-bearing deposits | 10,279 | | |
| | Securities available for sale, at fair value | 162,833 | | 1 |
| | Securities held to maturity (fair value approximates \$109,513 at December 31, 2005 and \$107,697 at December 31, 2004) | 109,708 | | 1 |
| | Mortgage loans held for sale | --- | | |
| | Loans: | | | |
| | Real estate construction loans | 27,116 | | |
| | Real estate mortgage loans | 117,421 | | 1 |
| | Commercial and industrial loans | 264,149 | | 2 |
| | Loans to individuals | 84,838 | | |
| | | ----- | | |
| | Total loans | 493,524 | | 4 |
| | Less unearned income and deferred fees | (913) | | |
| | | ---- | | |
| | Loans, net of unearned income and deferred fees | 492,611 | | 4 |
| | Less allowance for loan losses | (5,449) | | |
| | | ----- | | |
| | Loans, net | 487,162 | | 4 |
| | | ----- | | |
| | Premises and equipment, net | 12,808 | | |
| | Accrued interest receivable | 5,145 | | |
| | Other real estate owned, net | 376 | | |
| | Intangible assets and goodwill | 17,113 | | |
| | Other assets | 15,959 | | |
| | | ----- | | |
| | Total assets | \$ 841,498 | | \$ 7 |
| | | ===== | | ==== |
| Liabilities and | Noninterest-bearing demand deposits | \$ 112,445 | | 1 |

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| | | | |
|----------------------|---|------------|-------|
| Stockholders' Equity | Interest-bearing demand deposits | 225,611 | 1 |
| | Saving deposits | 54,505 | |
| | Time deposits | 353,088 | 3 |
| | | ----- | |
| | Total deposits | 745,649 | 7 |
| | | ----- | |
| | Other borrowed funds | 357 | |
| | Accrued interest payable | 725 | |
| | Other liabilities | 2,828 | |
| | | ----- | |
| | Total liabilities | 749,559 | 7 |
| | | ----- | |
| | Commitments and contingencies | | |
| | Stockholders' equity: | | |
| | Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding | --- | |
| | Common stock of \$2.50 par value. Authorized 10,000,000 shares; issued and outstanding, 3,509,937 shares - 2005, and 3,519,002 - 2004 | 8,775 | |
| | Retained earnings | 84,610 | |
| | Accumulated other comprehensive income (loss), net | (1,446) | |
| | | ----- | |
| | Total stockholders' equity | 91,939 | |
| | | ----- | |
| | Total liabilities and stockholders' equity | \$ 841,498 | \$ 7 |
| | | ===== | ===== |

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

35

CONSOLIDATED STATEMENTS OF INCOME

\$ In thousands, except per share data. Years ended December 31,

| | | 2005 | 2004 | 2003 |
|------------------|--|-----------|-----------|-----------|
| Interest Income | Interest and fees on loans | \$ 33,234 | \$ 29,812 | \$ 29,700 |
| | Interest on federal funds sold | --- | 5 | |
| | Interest on interest-bearing deposits | 508 | 196 | 200 |
| | Interest on securities - taxable | 6,501 | 6,184 | 5,600 |
| | Interest on securities - nontaxable | 5,137 | 5,295 | 5,300 |
| | | ----- | ----- | ----- |
| | Total interest income | 45,380 | 41,492 | 41,000 |
| | | ----- | ----- | ----- |
| Interest Expense | Interest on time deposits of \$100,000 or more | 3,942 | 3,138 | 3,000 |
| | Interest on other deposits | 10,215 | 7,973 | 9,200 |
| | Interest on borrowed funds | 23 | 14 | |
| | | -- | -- | |
| | Total interest expense | 14,180 | 11,125 | 12,200 |
| | | ----- | ----- | ----- |
| | Net interest income | 31,200 | 30,367 | 28,800 |
| | Provision for loan losses | 567 | 1,189 | 1,600 |
| | | --- | ----- | ----- |

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| | | | | |
|------------------------|--|-----------|-----------|---------|
| | Net interest income after provision for loan losses | 30,633 | 29,178 | 27,1 |
| | | ----- | ----- | ----- |
| Noninterest Income | Service charges on deposit accounts | 3,099 | 3,003 | 2,5 |
| | Other service charges and fees | 298 | 252 | 2 |
| | Credit card fees | 2,179 | 1,839 | 1,6 |
| | Trust income | 1,398 | 1,436 | 1,1 |
| | Other income | 639 | 444 | 4 |
| | Realized securities gains, net | --- | 168 | 1 |
| | | --- | --- | --- |
| | Total noninterest income | 7,613 | 7,142 | 6,1 |
| | | ----- | ----- | ----- |
| Noninterest Expense | Salaries and employee benefits | 11,265 | 10,498 | 9,5 |
| | Occupancy and furniture and fixtures | 1,931 | 1,797 | 1,6 |
| | Data processing and ATM | 1,455 | 1,302 | 1,1 |
| | Credit card processing | 1,687 | 1,502 | 1,2 |
| | Intangible assets and goodwill amortization | 1,117 | 967 | 9 |
| | Net costs of other real estate owned | 275 | 201 | 1 |
| | Other operating expenses | 4,168 | 4,069 | 3,8 |
| | | ----- | ----- | ----- |
| | Total noninterest expense | 21,898 | 20,336 | 18,6 |
| | | ----- | ----- | ----- |
| | Income before income taxes | 16,348 | 15,984 | 14,6 |
| | Income tax expense | 3,924 | 3,754 | 3,2 |
| | | ----- | ----- | ----- |
| | Net income | \$ 12,424 | \$ 12,230 | \$ 11,4 |
| | | ===== | ===== | ===== |
| | Basic net income per share | \$ 3.54 | \$ 3.48 | \$ 3. |
| | | ===== | ===== | ===== |
| | Fully diluted net income per share | \$ 3.52 | \$ 3.46 | \$ 3. |
| | | ===== | ===== | ===== |

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

36

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY \$ In thousands, except per share data.

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Comprehensive Income | Tota |
|---|-----------------|----------------------|--|-------------------------|-------|
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2002 | \$ 8,778 | \$ 62,525 | \$ 1,798 | | \$ 7 |
| Net income | --- | 11,442 | --- | 11,442 | 1 |
| Other comprehensive loss: | | | | | |
| Unrealized holding gains on available for sale securities net of deferred taxes of \$28 | --- | --- | --- | 52 | |
| Less: reclassification adjustment, net of income taxes of \$(46) | --- | --- | --- | (84) | |
| Minimum pension liability adjustment net of deferred taxes of \$8 | --- | --- | --- | 24 | |
| | | | | ----- | |
| Other comprehensive loss, net of | | | | | |

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| | | | | | |
|---|----------|-----------|------------|-----------|------|
| tax of \$(10) | --- | --- | (8) | (8) | |
| Total comprehensive income | --- | --- | --- | \$ 11,434 | |
| Cash dividends (\$1.13 per share) | --- | (3,971) | --- | | |
| Exercise of stock options | 10 | 67 | --- | | |
| Balance at December 31, 2003 | \$ 8,788 | 70,063 | \$ 1,790 | | \$ 8 |
| Net income | --- | 12,230 | --- | \$ 12,230 | \$ 1 |
| Other comprehensive loss: | | | | | |
| Unrealized holding losses on available for sale securities net of deferred taxes of \$(516) | --- | --- | --- | (958) | |
| Less: reclassification adjustment, net of income taxes of \$7 | --- | --- | --- | 12 | |
| Minimum pension liability adjustment, net of deferred taxes of \$(155) | --- | --- | --- | (288) | |
| Other comprehensive loss, net of tax of \$(664) | --- | --- | (1,234) | (1,234) | |
| Total comprehensive income | --- | --- | --- | \$ 10,996 | |
| Cash dividend (\$1.28 per share) | --- | (4,504) | --- | | |
| Exercise of stock options | 22 | 150 | --- | | |
| Common stock repurchase | (13) | (204) | --- | | |
| Balance at December 31, 2004 | \$ 8,797 | \$ 77,735 | \$ 556 | | \$ 8 |
| Net income | --- | 12,424 | --- | 12,424 | 1 |
| Other comprehensive loss: | | | | | |
| Unrealized holding losses on available for sale securities net of deferred taxes of \$(1,026) | --- | --- | --- | (1,906) | |
| Less: reclassification adjustment, net of income taxes of \$(66) | --- | --- | --- | (123) | |
| Minimum pension liability adjustment, net of deferred taxes of \$14 | --- | --- | --- | 27 | |
| Other comprehensive loss, net of tax of \$(1,078) | --- | --- | (2,002) | (2,002) | |
| Total comprehensive income | --- | --- | --- | \$ 10,422 | |
| Cash dividend (\$1.42 per share) | --- | (4,991) | --- | | |
| Exercise of stock options | 17 | 147 | --- | | |
| Common stock repurchase | (39) | (705) | --- | | |
| Balance at December 31, 2005 | \$ 8,775 | \$ 84,610 | \$ (1,446) | | \$ 9 |

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS
 Years Ended December 31,
 \$ in thousands

| | | 2005 | 2004 | 2003 |
|------------|--|----------|----------|----------|
| | | ----- | ----- | ----- |
| Cash | Net income | \$12,424 | 12,230 | 11,111 |
| Flows | Adjustment to reconcile net income to net cash | | | |
| from | provided by operating activities: | | | |
| Operating | Provision for loan losses | 567 | 1,189 | 1,189 |
| Activities | Deferred income tax expense (benefit) | 69 | (18) | (18) |
| | Depreciation of premises and equipment | 1,017 | 953 | 953 |
| | Amortization of intangibles | 1,117 | 967 | 967 |
| | Amortization of premiums and accretion of discounts, net | 395 | 335 | 335 |
| | (Gains) losses on sale and calls of securities available for sale, net | (189) | 95 | 95 |
| | (Gains) losses on calls of securities held to maturity, net | 189 | (263) | (263) |
| | Losses and writedowns on other real estate owned | 137 | 139 | 139 |
| | Originations of mortgage loans held for sale | (16,912) | (17,938) | (17,938) |
| | Sales of mortgage loans held for sale | 17,915 | 17,649 | 17,649 |
| | Losses on sale and disposal of fixed assets | 7 | --- | --- |
| | Net change in: | | | |
| | Accrued interest receivable | (275) | (260) | (260) |
| | Other assets | (1,716) | 8,253 | 8,253 |
| | Accrued interest payable | 242 | (6) | (6) |
| | Other liabilities | 474 | 9 | 9 |
| | | --- | - | - |
| | Net cash provided by operating activities | 15,461 | 23,334 | 14,111 |
| | | ----- | ----- | ----- |
| Cash | Net change in federal funds sold | --- | --- | 1,111 |
| Flows | Net change in interest-bearing deposits | 12,184 | 13,757 | (17,938) |
| from | Proceeds from repayments of mortgage-backed securities | 7,333 | 7,373 | 9,111 |
| Investing | Proceeds from sales of securities available for sale | 2,999 | 94 | 1,111 |
| Activities | Proceeds from calls and maturities of securities available for sale | 12,663 | 18,765 | 15,111 |
| | Proceeds from calls and maturities of securities held to maturity | 13,379 | 7,971 | 20,111 |
| | Proceeds from the sale of securities held to maturity | 3,312 | 1,310 | 1,111 |
| | Purchases of securities available for sale | (42,635) | (31,849) | (35,111) |
| | Purchases of securities held to maturity | (22,404) | (15,788) | (23,111) |
| | Purchases of loan participations | (3,715) | (1,668) | (6,111) |
| | Collections of loan participations | 1,361 | 1,499 | 9,111 |
| | Acquisitions, net of cash received | 13,178 | (8,022) | --- |
| | Loan originations and principal collections, net | (4,764) | (30,495) | (3,111) |
| | Purchase of bank owned life insurance | (12,000) | --- | --- |
| | Proceeds from disposal of other real estate owned | 547 | 1,031 | --- |
| | Recoveries on loans charged off | 254 | 223 | --- |
| | Additions to premises and equipment | (1,748) | (2,966) | (1,111) |
| | Proceeds from sale of premises and equipment | 20 | 3 | --- |
| | | -- | - | - |
| | Net cash used by investing activities | (20,036) | (38,762) | (27,111) |
| | | ----- | ----- | ----- |
| Cash | Net change in time deposits | 7,492 | 495 | (3,111) |
| Flows | Net change in other deposits | 10,216 | 20,080 | 20,111 |
| from | Net change in other borrowed funds | 60 | 162 | --- |
| Financing | Cash dividends paid | (4,991) | (4,504) | (3,111) |
| Activities | Common stock repurchase | (744) | (217) | --- |

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| | | | | |
|--------------|--|----------|----------|------|
| | Stock options exercised | 164 | 172 | |
| | | --- | --- | |
| | Net cash provided by financing activities | 12,197 | 16,188 | 12 |
| | | ----- | ----- | -- |
| Supplemental | Net change in cash and due from banks | 7,622 | 760 | |
| Disclosures | Cash and due from banks at beginning of year | 12,493 | 11,733 | 12 |
| of Cash Flow | | ----- | ----- | -- |
| Information | Cash and due from banks at end of year | \$20,115 | \$12,493 | \$11 |
| | | ===== | ===== | == |
| | Interest paid on deposits and borrowed funds | \$13,938 | \$11,131 | \$12 |
| | | ===== | ===== | == |
| | Income taxes paid | 4,127 | 3,578 | 3 |
| Supplemental | Loans charged against the allowance for loan | | | |
| Disclosures | losses | 1,101 | 1,550 | 1 |
| of Noncash | Loans transferred to other real estate owned | 165 | 402 | 1 |
| Activities | Unrealized gain (loss) on securities available | | | |
| | for sale | (3,125) | (1,455) | |
| | Minimum pension liability adjustment | (41) | 428 | |

38

| | | | |
|--------------|--|--------|--------|
| CONSOLIDATED | STATEMENTS OF CASH FLOWS (continued) Transactions related to | | |
| | acquisitions: Increase in assets and liabilities: | | |
| | Investments | --- | 10,052 |
| | Loans | 8,831 | 40,371 |
| | Deposits | 22,009 | 59,979 |

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

39

Notes to Consolidated Financial Statements \$ In thousands, except share data and per share data.

Note 1: Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of National Bankshares, Inc. (Bankshares) and its wholly-owned subsidiaries, the National Bank of Blacksburg (NBB), Bank of Tazewell County (BTC), and National Bankshares Financial Services, Inc. (NBFS), (the Company). All significant intercompany balances and transactions have been eliminated in consolidation.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The following is a summary of the more significant accounting policies.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity

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securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. The Company has no securities classified as trading securities at December 31, 2005 or 2004.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Loans held for sale are generally sold with the mortgage servicing rights released by the Company.

Loans

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

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in the process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

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

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 uncollectibility of a loan balance 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 collectibility of the loans in light of historical experience; the nature, volume, and risk characteristics 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 relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as

impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified 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 the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures.

Rate Lock Commitments

The Company enters into commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans that are intended to be sold are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best effort contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the changes in the value of the underlying assets while taking into consideration the probability that the rate lock commitments will close. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on the rate lock commitments.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, net of accumulated depreciation. Depreciation is charged to expense over the estimated useful lives of the assets on the straight-line basis. Depreciable lives include 40 years for premises, 3-10 years for furniture and equipment, and 3 years for computer software. Costs of maintenance and repairs are charged to expense as

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incurred and improvements are capitalized.

Other Real Estate

Real estate acquired through, or in lieu of, foreclosure is held for sale and is initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other operating expenses.

Intangible Assets

Included in other assets are deposit intangibles of \$11,108 and \$10,882 at December 31, 2005 and 2004, respectively, and goodwill of \$6,005 and \$6,042 at December 31, 2005 and 2004, respectively. Deposit intangibles are being amortized on a straight-line basis over a ten- or twelve-year period, and goodwill still being amortized on a straight-line basis is over a fifteen-year period. Goodwill from the CNB acquisition is not being amortized, but is subject to annual impairment testing.

Stock-Based Compensation

At December 31, 2005, the Company had a stock-based employee compensation plan which is described more fully in Note 9. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

41

| | Years Ended December 31, | | |
|---|---------------------------------------|-----------|---------|
| | 2005 | 2004 | 2003 |
| | (In thousands, except per share data) | | |
| Net income as reported | \$ 12,424 | \$ 12,230 | 11,442 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards | (594) | (102) | (61) |
| Pro forma net income | 11,830 | 12,128 | 11,381 |
| Earnings per share: | | | |
| Basic-as reported | \$ 3.54 | \$ 3.48 | \$ 3.26 |
| Basic-pro forma | \$ 3.37 | \$ 3.45 | \$ 3.24 |
| Diluted-as reported | \$ 3.52 | \$ 3.46 | \$ 3.24 |
| Diluted-pro forma | \$ 3.35 | \$ 3.43 | \$ 3.22 |

Pension Plan

The Company sponsors a defined benefit pension plan, which covers substantially all full-time officers and employees. The benefits are based upon length of service and a percentage of the employee's compensation during the

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final years of employment. Pension costs are computed based upon the provisions of SFAS No. 87. The Company contributes to the pension plan amounts that are deductible for federal income tax purposes.

Income Taxes

Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Trust Assets and Income

Assets (other than cash deposits) held by the Trust Departments in a fiduciary or agency capacity for customers are not included in the consolidated financial statements since such items are not assets of the Company. Trust income is recognized on the accrual basis.

Earnings Per Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

The following shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

| | 2005 | 2004 | 2003 |
|--|-----------|-----------|-----------|
| | ---- | ---- | ---- |
| Average number of common shares outstanding | 3,514,529 | 3,517,982 | 3,512,896 |
| Effect of dilutive options | 16,314 | 19,944 | 20,364 |
| | ----- | ----- | ----- |
| Average number of common shares outstanding used to calculate diluted earnings per share | 3,530,843 | 3,537,926 | 3,533,260 |
| | ===== | ===== | ===== |

In 2005 and 2004, stock options representing 27,000 and 13,125 shares, respectively, were not included in the computation of diluted net income per share because to do so would have been anti-dilutive. There were no anti-dilutive stock options excluded during 2003.

Advertising

The Company practices the policy of charging advertising costs to expenses as incurred. In 2005, the Company charged \$210 to expenses, and in 2004, \$226 was expensed.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly

susceptible to significant change in the near term relate to the determination

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of the allowance for loan losses and the valuation of foreclosed real estate and deferred tax assets.

Changing economic conditions, adverse economic prospects for borrowers, as well as regulatory agency action as a result of examination, could cause NBB and BTC to recognize additions to the allowance for loan losses and may also affect the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.

Recent Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (FSP 115-1). The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock". The FSP applies to investments in debt and equity securities and cost-method investments. The application guidance within the FSP includes items to consider in determining whether an investment is impaired, evaluating if an impairment is other than temporary and recognizing impairment losses equal to the difference between the investment's cost and its fair value when an impairment is determined. FSP 115-1 is required for all reporting periods beginning after December 15, 2005. Earlier application is permitted. The Corporation does not anticipate the amendment will have a material effect on its financial statements.

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement No. 154, "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3" (SFAS No. 154). The new standard changes the requirements for the accounting for and reporting of a change in accounting principle. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Corporation does not anticipate this revision will have a material effect on its financial statements.

In December 2004, FASB issued Statement No. 123 (Revised 2004), "Share-Based Payment" (SFAS No. 154), which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. SFAS No. 123R replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R requires all share-based payments to employees to be valued using a fair value method on the date of grant and expensed based on that fair value over the applicable vesting period. SFAS No. 123R also amends SFAS No. 95 "Statement of Cash Flows" requiring the benefits of tax deductions in excess of recognized compensation cost be reported as financing instead of operating cash flows. The Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 (SAB No. 107), which expresses the SEC's views regarding the interaction between SFAS No. 123R and certain SEC rules and regulations. Additionally, SAB No. 107 provides guidance related to share-based

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payment transactions for public companies. The Corporation will be required to apply SFAS No. 123R as of the annual reporting period that begins after September 15, 2005. In December 2005, the Company accelerated the vesting of all unvested stock options (which totaled 71,000) in order to eliminate recognition of compensation expense associated with the affected options. The Company anticipates that the aggregate pre-tax compensation expense associated with the accelerated options that will be avoided by this action is approximately \$448,000, of which approximately \$168,000 would have been recognized in 2006. The Company will comply with SFAS No. 123R to account for compensation cost associated with stock options that may be granted in 2006 and subsequent years. The impact on future financial statements is unknown, as the grant and number of stock options is discretionary and is determined annually by the Company's board of directors.

In December 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer" (SOP 03-3). SOP 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes loans purchased by the Corporation or acquired in business combinations. SOP 03-3 does not apply to loans originated by the Corporation. The Corporation adopted the provisions of SOP 03-3 effective January 1, 2005. The initial implementation had no material effect on the Corporation's financial statements.

Note 2: Restriction on Cash

As members of the Federal Reserve System, the Company's subsidiary banks are required to maintain certain average reserve balances. For the final weekly

43

reporting period in the years ended December 31, 2005 and 2004, the aggregate amounts of daily average required balances approximated \$5,884 and \$3,138, respectively.

Note 3: Securities

The amortized cost and fair value of securities available for sale, with gross unrealized gains and losses, follows:

| Available for sale: | Amortized Cost | December 31, 2005 | | Fair |
|---|-------------------|------------------------------|-------------------------------|------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. Treasury | \$ 4,037 | \$ 3 | \$ 122 | |
| U.S. Government agencies and corporations | 22,774 | --- | 258 | |
| States and political subdivisions | 74,238 | 1,035 | 769 | |
| Mortgage-backed securities | 27,323 | 95 | 387 | |
| Corporate debt securities | 32,090 | 122 | 1,155 | |
| Federal Home Loan Bank stock-restricted | 1,671 | --- | --- | |
| Federal Reserve Bank stock-restricted | 209 | --- | --- | |
| Other securities | 1,770 | 157 | --- | |
| | ----- | --- | --- | |
| Total securities available for sale | \$ 164,112 | \$ 1,412 | \$ 2,691 | \$ |
| | ===== | ===== | ===== | == |

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| Available for sale: | December 31, 2004 | | | Fair Value |
|---|-------------------|------------------------|-------------------------|------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. Treasury | \$ 4,041 | \$ 32 | \$ 59 | \$ |
| U.S. Government agencies and corporations | 6,831 | 55 | 11 | |
| States and political subdivisions | 77,689 | 1,886 | 433 | 7 |
| Mortgage-backed securities | 17,609 | 284 | 29 | 1 |
| Corporate debt securities | 33,880 | 539 | 571 | 3 |
| Federal Home Loan Bank stock-restricted | 1,603 | --- | --- | |
| Federal Reserve Bank stock-restricted | 209 | --- | --- | |
| Other securities | 1,615 | 153 | --- | |
| | ----- | --- | --- | |
| Total securities available for sale | \$ 143,477 | \$ 2,949 | \$ 1,103 | \$ 14 |
| | ===== | ===== | ===== | ===== |

The amortized cost and fair value of single maturity securities available for sale at December 31, 2005, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2005.

| | December 31, 2005 | |
|--|-------------------|------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$ 2,239 | \$ 2,238 |
| Due after one year through five years | 46,094 | 45,420 |
| Due after five years through ten years | 95,398 | 94,553 |
| Due after ten years | 17,186 | 17,270 |
| No maturity | 3,195 | 3,352 |
| | ----- | ----- |
| | \$ 164,112 | \$ 162,833 |
| | ===== | ===== |

The amortized cost and fair value of securities held to maturity, with gross unrealized gains and losses, follows:

| Held to maturity: | December 31, 2005 | | | Fair Value |
|---|-------------------|------------------------|-------------------------|------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. Government agencies and corporations | \$ 28,603 | \$ --- | \$ 633 | \$ 27,970 |
| States and political subdivisions | 56,898 | 891 | 262 | 57,527 |
| Mortgage-backed securities | 3,994 | 54 | 35 | 4,013 |
| Corporate debt securities | 20,213 | 316 | 526 | 20,003 |
| | ----- | --- | --- | ----- |
| Total securities held to maturity | \$ 109,708 | \$1,261 | \$ 1,456 | \$ 109,513 |
| | ===== | ===== | ===== | ===== |

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44

| Held to maturity: | Amortized Cost | December 31, 2004 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. Government agencies and corporations | \$ 16,976 | \$ 40 | \$ 143 | \$ 16,873 |
| States and political subdivisions | 55,310 | 1,687 | 44 | 56,953 |
| Mortgage-backed securities | 3,054 | 113 | 2 | 3,165 |
| Corporate debt securities | 30,045 | 1,002 | 341 | 30,706 |
| | ----- | ----- | --- | ----- |
| | \$ 105,385 | \$2,842 | \$ 530 | \$ 107,697 |
| | ===== | ===== | === | ===== |
| Total securities held to maturity | | | | |

The amortized cost and fair value of single maturity securities held to maturity at December 31, 2005, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2005.

| | December 31, 2005 | |
|--|-------------------------|---------------|
| | Amortized Cost Value | Fair Value |
| Due in one year or less | \$ 3,002 | \$ 2,997 |
| Due after one year through five years | 41,367 | 41,491 |
| Due after five years through ten years | 53,009 | 52,881 |
| Due after ten years | 12,330 | 12,144 |
| | ----- | ----- |
| | \$ 109,708 | \$109,513 |
| | ===== | ===== |

Information pertaining to securities with gross unrealized losses at December 31, 2005 and 2004, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| | December 31, 2005 | | | |
|--|---------------------|--------------------|-------------------|--------------------|
| | Less Than 12 Months | | 12 Months or More | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 38,913 | 541 | \$ 11,698 | 485 |
| State and political subdivisions | 28,660 | 429 | 15,625 | 601 |
| Mortgage-backed securities | 22,169 | 333 | 3,132 | 76 |
| Corporate debt securities | 12,052 | 200 | 25,881 | 1,482 |
| | ----- | --- | ----- | ----- |
| Total temporarily impaired securities | \$ 101,794 | 1,503 | \$ 56,336 | 2,644 |
| | ===== | ===== | ===== | ===== |

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| | December 31, 2004 | | | |
|--|---------------------|-----------------|-------------------|-----------------|
| | Less Than 12 Months | | 12 Months or More | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 15,012 | 170 | \$ 3,862 | 43 |
| State and political subdivisions | 20,270 | 340 | 4,803 | 137 |
| Mortgage-backed securities | 5,173 | 31 | --- | --- |
| Corporate debt securities | 20,168 | 344 | 9,285 | 568 |
| | ----- | --- | ----- | --- |
| Total temporarily impaired securities | \$ 60,623 | 885 | \$ 17,950 | 748 |
| | ===== | === | ===== | === |

The Company had 242 securities with a fair value of \$158,130 which were temporarily impaired at December 31, 2005. The total unrealized loss on these securities was \$4,147. Losses are attributed to interest rate movements. Credit quality of the securities portfolio is continuously monitored by management. The Company has the ability and intent to hold these securities until maturity. Therefore, the losses associated with these securities are not considered other than temporary at December 31, 2005.

At December 31, 2005 and 2004, securities with a carrying value of \$60,409 and \$49,206, respectively, were pledged to secure trust deposits and for other purposes as required or permitted by law.

As members of the Federal Reserve and the Federal Home Loan Bank (FHLB) of Atlanta, NBB and BTC are required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB and BTC's capital and a percentage of qualifying assets. In addition, NBB and BTC are eligible to borrow from the FHLB with borrowings collateralized by qualifying assets, primarily residential mortgage loans totaling approximately \$109,140, and NBB and BTC's capital stock investment in the FHLB.

45

Note 4: Loans to Officers and Directors

In the ordinary course of business, the Company, through its banking subsidiaries, has granted loans to executive officers and directors of Bankshares and its subsidiaries amounting to \$3,941 at December 31, 2005 and \$2,526 at December 31, 2004. During the year ended December 31, 2005 total principal additions were \$3,184 and principal payments were \$1,769.

Note 5: Allowance for Loan Losses

An analysis of the allowance for loan losses follows:

| | Years ended December 31, | | |
|--|--------------------------|---------|---------|
| | 2005 | 2004 | 2003 |
| Balance at beginning of year | \$5,729 | \$5,369 | \$5,092 |
| Provision for loan losses | 567 | 1,189 | 1,691 |
| Loans charged off | (1,101) | (1,550) | (1,660) |
| Recoveries of loans previously charged off | 254 | 223 | 246 |
| Acquisition of bank | --- | 498 | --- |

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| | | | |
|------------------------|---------|---------|---------|
| Balance at end of year | \$5,449 | \$5,729 | \$5,369 |
| | ===== | ===== | ===== |

The following is a summary of information pertaining to impaired loans:

| | December 31, | | |
|---|--------------|--------|--------|
| | 2005 | 2004 | 2003 |
| Impaired loans without a valuation allowance | \$ 174 | \$ 275 | \$ 365 |
| Impaired loans with a valuation allowance | --- | 79 | 506 |
| Total impaired loans | \$ 174 | \$ 354 | \$ 871 |
| Valuation allowance related to impaired loans | --- | 55 | 135 |

| | Years ended December 31, | | |
|--|--------------------------|-------|-------|
| | 2005 | 2004 | 2003 |
| Average investment in impaired loans | \$274 | \$601 | \$353 |
| Interest income recognized on impaired loans | --- | --- | 66 |
| Interest income recognized on a cash basis on impaired loans | 11 | --- | --- |

No additional funds are committed to be advanced in connection with impaired loans. Nonaccrual loans excluded from impaired loan disclosure under FASB 114 at December 31, 2005 and 2004 were \$7 and \$40, respectively. If interest on these loans had been accrued, the income would have been \$0 and \$2 respectively. Loans past due greater than 90 days which continue to accrue interest totaled \$546 and \$754 at December 31, 2005 and 2004, respectively.

Note 6: Premises and Equipment

A summary of the cost and accumulated depreciation of premises and equipment follows:

| | December 31, | |
|--------------------------|-----------------------|--------------------|
| | 2005 | 2004 |
| Premises | \$ 14,028 | 12,985 |
| Furniture and equipment | 10,324 | 9,618 |
| Construction-in-progress | 460 | 564 |
| Accumulated depreciation | \$ 24,812 (12,004) | 23,167 (11,013) |
| | \$ 12,808 | 12,104 |

Depreciation expense for the years ended December 2005, 2004 and 2003 amounted to \$1,017, \$953 and \$924, respectively.

The Company leases branch facilities under noncancellable operating leases. The future minimum lease payments under these leases (with initial or remaining lease terms in excess of one year) as of December 31, 2005 are as follows: \$207 in 2006, \$220 in 2007, \$223 in 2008, \$193 in 2009, \$137 in 2010, and \$188 thereafter.

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Note 7: Deposits

The aggregate amounts of time deposits in denominations of \$100 or more at December 31, 2005 and 2004 were \$114,969 and \$105,336, respectively.

At December 31, 2005 the scheduled maturities of time deposits are as follows:

| | |
|------------|------------|
| 2006 | \$ 181,868 |
| 2007 | 68,448 |
| 2008 | 36,120 |
| 2009 | 26,616 |
| 2010 | 39,514 |
| Thereafter | 522 |
| | ----- |
| | \$ 353,088 |
| | ===== |

At December 31, 2005 and 2004, overdraft demand deposits reclassified to loans totaled \$491 and \$581, respectively.

Note 8: Employee Benefit Plans

401(k) Plan

The Company has a Retirement Accumulation Plan qualifying under IRS Code Section 401(k), in which Bankshares, NBB, BTC and NBFS are participating employers. Eligible participants may contribute up to 100% of their total annual compensation to the plan. Employee contributions are matched by the employer based on a percentage of an employee's total annual compensation contributed to the plan. For the years ended December 31, 2005, 2004 and 2003, NBB and BTC contributed \$275, \$260 and \$231, respectively, to the plan.

Employee Stock Ownership Plan

Bankshares has a nonleveraged Employee Stock Ownership Plan (ESOP) which enables employees of Bankshares and its subsidiaries who have one year of service and who have attained the age of 21 prior to the plan's January 1 and July 1 enrollment dates to own Bankshares common stock. Contributions to the ESOP are determined annually by the Board of Directors. Contribution expense amounted to \$373, \$410 and \$389 in the years ended December 31, 2005, 2004 and 2003, respectively. Dividends on ESOP shares are charged to retained earnings. As of December 31, 2005, the number of allocated shares held by the ESOP was 111,605 and the number of unallocated shares was 4,771. All shares held by the ESOP are treated as outstanding in computing the Company's basic net income per share. Upon reaching age 55 with ten years of plan participation, a vested participant has the right to diversify 50% of his or her allocated ESOP shares and Bankshares or the ESOP, with the agreement of the Trustee, is obligated to purchase those shares. The ESOP contains a put option which allows a withdrawing participant to require Bankshares or the ESOP, if the plan administrator agrees, to purchase his or her allocated shares if the shares are not readily tradable on an established market at the time of its distribution.

Defined Benefit Plan

The Company's plan covers substantially all employees. The plan benefit formula is based upon the length of service of retired employees and a percentage of qualified W-2 compensation during their final years of employment. Information pertaining to activity in the plan is as follows:

| | 2005 | December 31, 2004 | 2003 |
|---|-----------|----------------------|----------|
| | ----- | ----- | ----- |
| Change in benefit obligation | | | |
| Benefit obligation at beginning of year | \$ 10,220 | \$ 8,477 | \$ 7,078 |

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| | | | |
|--|----------|----------|----------|
| Service cost | 572 | 497 | 427 |
| Interest cost | 585 | 538 | 501 |
| Actuarial loss | 444 | 900 | 938 |
| Benefits paid | (1,089) | (192) | (467) |
| | ----- | ----- | ----- |
| Benefit obligation at end of year | 10,732 | 10,220 | 8,477 |
| | ----- | ----- | ----- |
| Change in plan assets | | | |
| Fair value of plan assets at beginning of year | 6,392 | 5,415 | 4,504 |
| Actual return on plan assets | 420 | 424 | 729 |
| Employer contribution | 505 | 745 | 649 |
| Benefits paid | (1,089) | (192) | (467) |
| | ----- | ----- | ----- |
| Fair value of plan assets at end of year | 6,228 | 6,392 | 5,415 |
| | ----- | ----- | ----- |
| Funded status | (4,504) | (3,828) | (3,062) |
| Unrecognized net actuarial loss | 3,981 | 3,561 | 2,693 |
| Unrecognized prior service cost | 46 | 55 | 64 |
| Unrecognized transition asset | (64) | (76) | (88) |
| | ----- | ----- | ----- |
| Net accrued pension cost | \$ (541) | \$ (288) | \$ (393) |
| | ===== | ===== | ===== |

47

The accumulated benefit obligations at December 31, 2005, 2004 and 2003 were \$7,790, \$7,756 and \$6,456, respectively.

Amounts recognized in the consolidated balance sheets:

| | 2005 | December 31, 2004 | 2003 |
|--|------------|----------------------|------------|
| | ----- | ----- | ----- |
| Accrued benefit liabilities | \$ (1,562) | \$ (1,364) | \$ (1,041) |
| Intangible asset | 46 | 55 | 64 |
| Deferred tax asset | 357 | 376 | 227 |
| Accumulated other comprehensive income | 618 | 645 | 357 |
| | --- | --- | --- |
| Net amount recognized | \$ (541) | \$ (288) | \$ (393) |
| | ===== | ===== | ===== |

The components of net periodic cost are as follows:

| | 2005 | Years ended December 31, 2004 | 2003 |
|------------------------------------|--------|----------------------------------|--------|
| | ----- | ----- | ----- |
| Service cost | \$ 572 | \$ 498 | \$ 427 |
| Interest cost | 585 | 538 | 501 |
| Expected return on plan assets | (547) | (512) | (418) |
| Amortization of prior service cost | 9 | 9 | 9 |
| Recognized net actuarial loss | 151 | 120 | 111 |
| Amortization of transition asset | (12) | (13) | (13) |
| | ---- | ---- | ---- |
| Net periodic benefit cost | \$ 758 | \$ 640 | \$ 617 |
| | ===== | ==== | ==== |

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The weighted average assumptions used to determine benefit obligations are as follows:

| | 2005 | 2004 | 2003 |
|---|-------|-------|-------|
| Weighted assumptions as of December 31, | | | |
| Weighted average discount rate | 6.00% | 6.00% | 6.50% |
| Expected return on plan assets | 9.00% | 9.00% | 9.00% |
| Rate of compensation increases | 4.00% | 4.00% | 4.00% |

The weighted average assumptions used to determine net periodic benefit cost are as follows:

| | 2005 | 2004 | 2003 |
|---|-------|-------|-------|
| Weighted average assumptions as of December 31, | | | |
| Weighted average discount rate | 6.00% | 6.50% | 7.00% |
| Expected return on plan assets | 9.00% | 9.00% | 9.00% |
| Rate of compensation increase | 4.00% | 4.00% | 4.00% |

Long Term Rate of Return

The Company, as plan sponsor, selects the expected long-term rate-of-return-on-assets assumption in consultation with its 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, which may not continue over the measurement period, but other higher significance is 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, and solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

The Company, as plan sponsor, has adopted a Pension Administrative Committee Policy (the Policy) for monitoring the investment management of its qualified plans. The Policy includes a statement of general investment principles and a listing of specific investment guidelines, to which the committee may make documented exceptions. The guidelines state that, unless otherwise indicated, all investments that are permitted under the Prudent Investor Rule shall be permissible investments for the pension plan. All plan assets are to be invested in marketable securities. Certain investments are prohibited, including commodities and future contracts, private placements, repurchase agreements, options, and derivatives and stocks and ADR's of non-U.S. companies. The Policy establishes quality standards for fixed income investments and mutual funds included in the pension plan trust. The Policy also outlines diversification and asset allocation standards.

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The pension plan's weighted average asset allocations at October 31, 2005 and 2004 are as follows:

| Asset Allocation | 2005 | 2004 |
|------------------------------|-------|-------|
| ----- | ----- | ----- |
| U. S. Government obligations | 17% | 13% |
| Mutual funds - equity | 30% | 39% |
| Corporate bonds | 14% | 14% |
| Equity securities | 33% | 31% |
| Other | 6% | 3% |
| | -- | -- |
| | 100% | 100% |
| | ===== | ===== |

The Company expects to contribute \$293 to the plan in 2006.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

| | |
|-------------|-------|
| 2006 | \$ 66 |
| 2007 | 71 |
| 2008 | 132 |
| 2009 | 336 |
| 2010 | 398 |
| 2011 - 2015 | 3,413 |

Note 9: Stock Option Plan

The Company adopted the National Bankshares, Inc. 1999 Stock Option Plan to give key employees of Bankshares and its subsidiaries an opportunity to acquire shares of National Bankshares, Inc. common stock. The purpose of the 1999 Stock Option Plan is to promote the success of Bankshares and its subsidiaries by providing an incentive to key employees that enhances the identification of their personal interest with the long term financial success of the Company and with growth in stockholder value. Under the 1999 Stock Option Plan, up to 250,000 shares of Bankshares common stock may be granted. The 1999 Stock Option Plan is administered by the Stock Option Committee, which is the NBI Board of Directors' Compensation Committee, made up entirely of independent directors of National Bankshares, Inc. The Stock Option Committee may determine whether options are incentive stock options or nonqualified stock options and may determine the other terms of grants, such as number of shares, term, a vesting schedule, and the exercise price. The 1999 Stock Option Plan limits the maximum term of any option granted to ten years, states that options may be granted at not less than fair market value on the date of the grant and contains certain other limitations on the exercisability of incentive stock options. The options generally vest 25% after one year, 50% after two years, 75% after three years and 100% after four years. On December 29, 2005, the Company's Board of Directors passed a resolution stating that all 71,000 previously granted, but unvested, stock options be immediately vested. The vesting was made subject to the provision that any shares of NBI common stock obtained by an option grantee by exercise of an option subject to accelerated vesting may not be sold or otherwise transferred prior to the expiration of the option's original vesting period. This action was taken to reduce the impact of the "Statement of Financial Accounting Standards No. 123R, Share-Based Payment" on the Company's earnings over the remainder vesting period of the stock options. At the discretion of the Stock Option Committee, options may be awarded with the provision that they may be accelerated upon a change of control, merger, consolidation, sale or dissolution of National Bankshares, Inc. At December 31, 2005, there were 143,000 additional shares available for grant under the plan.

A summary of the status of the Company's stock option plan is presented below:

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| | 2005 | | 2004 | | 2003 |
|--|------------------|---------------------------------|------------------|---------------------------------|------------------|
| | Number of Shares | Weighted Average Exercise Price | Number of Shares | Weighted Average Exercise Price | Number of Shares |
| Outstanding, beginning of year | 74,875 | \$ 36.53 | 64,000 | \$ 30.24 | 51,500 |
| Granted | 19,500 | 46.00 | 19,500 | 49.85 | 16,500 |
| Exercised | (6,875) | 23.80 | (8,625) | 19.95 | (4,000) |
| Forfeited | (1,250) | 28.32 | --- | --- | --- |
| Outstanding, end of year | 86,250 | \$ 39.81 | 74,875 | \$ 36.53 | 64,000 |
| Options exercisable at year-end | 86,250 | \$ 39.81 | 30,500 | \$ 27.55 | 24,12 |
| Weighted-average fair value of options granted during the year | | \$ 8.39 | | \$ 11.62 | |

49

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

| | Years Ended December 31, | | |
|-------------------------|--------------------------|----------|----------|
| | 2005 | 2004 | 2003 |
| Dividend yield | 3.13% | 1.74% | 1.73% |
| Expected life | 5 years | 10 years | 10 years |
| Expected volatility | 21.35% | 23.54% | 22.14% |
| Risk-free interest rate | 4.41% | 4.60% | 4.82% |

Information pertaining to options outstanding at December 31, 2005 is as follows:

| Remaining Contractual Life | Options Outstanding and Exercisable | | |
|----------------------------|-------------------------------------|--------------------|---------------------------------|
| | Exercise Price | Number Outstanding | Weighted Average Exercise Price |
| 9.83 years | \$46.00 | 19,500 | \$46.00 |
| 8.83 years | 49.85 | 19,500 | 49.85 |
| 7.83 years | 46.65 | 16,500 | 46.65 |
| 6.83 years | 29.65 | 15,500 | 29.65 |
| 5.83 years | 23.00 | 10,000 | 23.00 |
| 4.83 years | 18.75 | 3,250 | 18.75 |
| 3.83 years | 22.00 | 2,000 | 22.00 |

Note 10: Income Taxes

Allocation of income tax expense between current and deferred portions is as follows:

| | Years ended December 31, | | |
|--|--------------------------|------|------|
| | 2005 | 2004 | 2003 |
| | | | |

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| | | | |
|--------------------------|---------|---------|---------|
| Current | \$3,855 | \$3,772 | \$3,436 |
| Deferred | 69 | (18) | (200) |
| | ----- | ----- | ----- |
| Total income tax expense | \$3,924 | \$3,754 | 3,236 |

The following is a reconciliation of the "expected" income tax expense, computed by applying the U.S. Federal income tax rate of 35% to income before income tax expense, with the reported income tax expense:

| | Years ended December 31, | | |
|--|--------------------------|---------|---------|
| | 2005 | 2004 | 2003 |
| | ----- | ----- | ----- |
| Computed "expected" income tax expense | \$5,722 | \$5,594 | \$5,137 |
| Tax-exempt interest income | (1,947) | (1,943) | (1,977) |
| Nondeductible interest expense | 196 | 149 | 169 |
| Other, net | (47) | (46) | (93) |
| | ----- | ----- | ----- |
| Reported income tax expense | \$3,924 | \$3,754 | \$3,236 |
| | ===== | ===== | ===== |

50

The components of the net deferred tax asset, included in other assets, are as follows:

| | December 31, | |
|--|--------------|----------|
| | 2005 | 2004 |
| | ----- | ----- |
| Deferred tax assets: | | |
| Allowance for loan losses and unearned fee income | \$ 1,905 | \$ 2,017 |
| Valuation allowance on other real estate owned | 29 | 23 |
| Deferred compensation and other liabilities | 499 | 498 |
| Deposit intangibles and goodwill | 2 | 23 |
| Net unrealized losses on securities available for sale | 446 | --- |
| | ----- | ----- |
| | \$ 2,881 | \$ 2,561 |
| | ----- | ----- |
| Deferred tax liabilities: | | |
| Net unrealized gains on securities available for sale | \$ --- | \$ (647) |
| Fixed assets | (207) | (282) |
| Discount accretion on securities | (105) | (80) |
| Other | (128) | (116) |
| | ----- | ----- |
| | (440) | (1,125) |
| Net deferred tax asset | \$ 2,441 | \$ 1,436 |
| | ===== | ===== |

The Company has determined that a valuation allowance for the gross deferred tax assets is not necessary at December 31, 2005 and 2004 due to the fact that the realization of the entire gross deferred tax assets can be supported by the amount of taxes paid during the carryback period available under current tax laws.

Note 11: Restrictions on Dividends

Bankshares' principal source of funds for dividend payments is dividends

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received from its subsidiary banks. For the years ended December 31, 2005, 2004, and 2003, dividends received from subsidiary banks were \$5,795, \$4,504 and \$5,377, respectively.

Substantially all of Bankshares' retained earnings are undistributed earnings of its banking subsidiaries, which are restricted by various regulations administered by federal and state bank regulatory agencies. Bank regulatory agencies restrict, without prior approval, the total dividend payments of a bank in any calendar year to the bank's retained net income of that year to date, as defined, combined with its retained net income of the preceding two years, less any required transfers to surplus. At December 31, 2005, retained net income, which was free of such restriction, amounted to approximately \$20,750.

Note 12: Minimum Regulatory Capital Requirement

The Company (on a consolidated basis) and the subsidiary banks are subject to various regulatory capital requirements administered by the federal 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 Company's and the banks' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the banks must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the banks to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2005 and 2004, that the Company and the banks meet all capital adequacy requirements to which they are subject.

As of December 31, 2005, the most recent notifications from the appropriate regulatory authorities categorized the banks as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since these notifications that management believes have changed the banks' category. The Company's and the banks' actual capital amounts and ratios as of December 31, 2005 and 2004 are also presented in the following tables.

51

| | Actual | | Minimum Capital Requirement | | Minimum T |
|---|----------|-------|-----------------------------|-------|-----------|
| | Amount | Ratio | Amount | Ratio | Capitaliz |
| December 31, 2005 | | | | | |
| Total capital (to risk weighted assets) | | | | | |
| Bankshares consolidated | \$81,745 | 14.1% | \$46,446 | 8.0% | N/A |
| NBB | 44,929 | 12.4% | 28,955 | 8.0% | \$ 36,194 |

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| | | | | | |
|--|----------|-------|----------|------|-----------|
| BTC | 32,181 | 15.1% | 17,102 | 8.0% | 21,378 |
| Tier 1 capital (to risk weighted assets) | | | | | |
| Bankshares consolidated | \$76,233 | 13.1% | \$23,223 | 4.0% | N/A |
| NBB | 41,944 | 11.6% | 14,477 | 4.0% | \$ 21,716 |
| BTC | 29,717 | 13.9% | 8,551 | 4.0% | 12,827 |
| Tier 1 capital (to average assets) | | | | | |
| Bankshares consolidated | \$76,233 | 9.3% | \$32,634 | 4.0% | N/A |
| NBB | 41,944 | 8.8% | 18,984 | 4.0% | \$ 23,730 |
| BTC | 29,717 | 8.9% | 13,399 | 4.0% | 16,749 |

| | Actual | | Minimum Capital Requirement | | Minimum Capital Prompt Action |
|--|----------|-------|-----------------------------|-------|-------------------------------|
| | Amount | Ratio | Amount | Ratio | |
| December 31, 2004 | | | | | |
| Total capital (to risk weighted assets) | | | | | |
| Bankshares consolidated | \$75,364 | 13.4% | \$45,018 | 8.00% | |
| NBB | 39,990 | 11.4% | 28,100 | 8.00% | \$ 35, |
| BTC | 30,877 | 14.9% | 16,598 | 8.00% | 20, |
| Tier 1 capital (to risk weighted assets) | | | | | |
| Bankshares consolidated | \$69,574 | 12.4% | \$22,509 | 4.00% | |
| NBB | 36,692 | 10.5% | 14,050 | 4.00% | \$ 21, |
| BTC | 28,446 | 13.7% | 8,299 | 4.00% | 12, |
| Tier 1 capital (to average assets) | | | | | |
| Bankshares consolidated | \$69,574 | 9.0% | \$30,918 | 4.00% | |
| NBB | 36,692 | 8.1% | 18,220 | 4.00% | \$ 22, |
| BTC | 28,446 | 9.3% | 12,193 | 4.00% | 15, |

Note 13: Condensed Financial Statements of Parent Company
Financial information pertaining only to Bankshares (Parent) is as follows:

| Condensed Balance Sheets | | December 31, | |
|--------------------------|--|--------------|--------|
| | | 2005 | 2004 |
| Assets | Cash due from subsidiaries | \$ 58 | \$ 91 |
| | Securities available for sale | 3,736 | 3,729 |
| | Investments in subsidiaries, at equity | 87,902 | 83,117 |
| | Refundable income taxes due from | | |

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| | | | |
|---------------|--|----------|----------|
| | subsidiaries | 98 | 107 |
| | Other assets | 455 | 207 |
| | | --- | --- |
| | Total assets | \$92,249 | \$87,251 |
| | | ===== | ===== |
| Liabilities | Other liabilities | \$310 | \$163 |
| And | Stockholders' equity | 91,939 | 87,088 |
| Stockholders' | | ----- | ----- |
| Equity | Total liabilities and stockholders' equity | \$92,249 | \$87,251 |
| | | ===== | ===== |

Condensed Statements of Income

| | | Years Ended December 31, | | |
|----------|---|--------------------------|----------|-------|
| | | 2005 | 2004 | 2003 |
| | | ----- | ----- | ----- |
| Income | Dividends from Subsidiaries | \$5,795 | \$4,504 | \$5 |
| | Interest on securities - taxable | 26 | 13 | |
| | Interest on securities - nontaxable | 117 | 122 | |
| | Other income | 1,072 | 895 | |
| | Securities gains (losses) | 25 | 8 | |
| | | -- | - | |
| | | 7,035 | 5,542 | 6 |
| Expenses | Other expenses | 1,519 | 1,214 | |
| | | ----- | ----- | |
| | Income before income tax benefit (expense) and equity in undistributed net income of subsidiaries | 5,516 | 4,328 | 5 |
| | Applicable income tax benefit | 136 | 102 | |
| | | --- | --- | |
| | Income before equity in undistributed net income of subsidiaries | 5,652 | 4,430 | 5 |
| | Equity in undistributed net income of subsidiaries | 6,772 | 7,800 | 6 |
| | | ----- | ----- | --- |
| | Net income | \$12,424 | \$12,230 | \$11 |
| | | ===== | ===== | ===== |

Condensed Statements of Cash Flows

| | | Years ended December 31, | | |
|------------------------------------|---|--------------------------|-----------|-------|
| | | 2005 | 2004 | 2003 |
| | | ----- | ----- | ----- |
| Cash Flows From Operating Expenses | Net income | \$ 12,424 | \$ 12,230 | \$ 11 |
| | Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| | Equity in undistributed net income of subsidiaries | (6,772) | (7,800) | (6) |
| | Amortization of premiums and accretion of discounts, net | 11 | 3 | |
| | Depreciation expense | 4 | 1 | |
| | Securities (gains) losses | (25) | (8) | |
| | Net change in refundable income taxes due from subsidiaries | 9 | 4 | |
| | Net change in other assets | (248) | (133) | |
| | Net change in other liabilities | 162 | (17) | |
| | | --- | ---- | |

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| | | | |
|---|-------|-------|---|
| Net cash provided by operating activities | 5,565 | 4,280 | 5 |
| | ----- | ----- | |

53

| | | | | |
|--------------------------------------|--|---------|---------|-----|
| Cash Flows from Investing Activities | Purchases of securities available for sale | (1,414) | (1,396) | (1 |
| | Proceeds from sales of securities available for sale | 1,387 | 1,135 | |
| | Calls of securities available for sale | --- | --- | |
| | | --- | --- | |
| | Net cash (used in) investing activities | (27) | (261) | |
| | | ----- | ----- | |
| Cash Flows from Financing Activities | Cash dividends paid | (4,991) | (4,504) | (3 |
| | Common stock repurchase | (744) | (217) | |
| | Exercise of stock options | 164 | 172 | |
| | | --- | --- | |
| | Net cash used in financing activities | (5,571) | (4,549) | (3 |
| | | ----- | ----- | --- |
| | Net change in cash | (33) | (530) | |
| | Cash due from subsidiaries at beginning of year | 91 | 621 | |
| | | -- | --- | |
| | Cash due from subsidiaries at end of year | \$ 58 | \$ 91 | \$ |
| | | ===== | ===== | = |

=Note 14: Financial Instruments with Off-Balance Sheet Risk

The Company is a 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; standby letters of credit and interest rate locks. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Company'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 Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support the following financial instruments with credit risk.

At December 31, 2005, and 2004, financial instruments were outstanding whose contract amounts represent credit risk:

| | December 31, 2005 | 2004 |
|---|----------------------|------------|
| | ----- | ----- |
| Financial instruments whose contract amounts represent credit risk: | | |
| Commitments to extend credit | \$ 108,885 | \$ 103,816 |
| Standby letters of credit | 5,137 | 4,365 |
| Mortgage loans sold with potential recourse | 17,915 | 17,649 |

Commitments to extend credit are agreements to lend to a customer as long as

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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. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit. Some of these commitments are uncollateralized and do not contain a specified maturity date and may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

The Company originates mortgage loans for sale to secondary market investors subject to contractually specified and limited recourse provisions. In 2005, the Company originated \$16,912 and sold \$17,915 to investors, compared to \$17,938 originated and \$17,649 sold in 2004. Every contract with each investor contains certain recourse language. In general, the Company may be required to repurchase a previously sold mortgage loan if there is major noncompliance with defined loan origination or documentation standards, including fraud, negligence or material misstatement in the loan documents. Repurchase may also be required if necessary governmental loan guarantees are canceled or never issued, or if an investor is forced to buy back a loan after it has been resold as a part of a loan pool. In addition, the Company may have an obligation to repurchase a loan if the mortgagor has defaulted early in the loan term. This potential default period is approximately twelve months after sale of a loan to the investor.

At December 31, 2005, the Company had locked-rate commitments to originate mortgage loans amounting to approximately \$802 and loans held for sale of \$0. The Company has entered into commitments, on a best-effort basis, to sell loans of approximately \$1,238. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Company does not expect any counterparty to fail to meet its obligations.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2005 that exceeded the insurance limits of the Federal Deposit Insurance Corporation was \$10,004.

54

Note 15: Concentrations of Credit Risk

The Company does a general banking business, serving the commercial and personal banking needs of its customers. NBB's market area, commonly referred to as Virginia's New River Valley and Mountain Empire, consists of Montgomery, Giles and Pulaski Counties and the cities of Radford and Galax, together with portions of adjacent counties. BTC's market area adjoins NBB's and includes the counties of Tazewell, Wythe, Smyth and Washington in Virginia, as well as contiguous portions of McDowell and Mercer Counties in West Virginia. Substantially all of NBB's and BTC's loans are made within their market area. The ultimate collectibility of the banks' loan portfolios and the ability to realize the value of any underlying collateral, if needed, are influenced by the economic conditions of the market area. The Company's operating results are therefore closely correlated with the economic trends within this area.

At December 31, 2005 and 2004, approximately \$255,230 and \$236,464, respectively, of the loan portfolio was concentrated in commercial real estate. This represents approximately 52% and 49% of the loan portfolio at December 31, 2005 and 2004, respectively. Included in commercial loans at December 31, 2005 and 2004 was approximately \$121,265 and \$142,768, respectively, in loans for

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college housing and professional office buildings. This represents approximately 25% and 30% of the loan portfolio at December 31, 2005 and 2004, respectively. Loans secured by residential real estate were approximately \$147,955 and \$139,213 at December 31, 2005 and 2004, respectively. This represents approximately 30% of the loan portfolio at December 31, 2005 and 2004, respectively. Loans secured by automobiles were approximately \$17,309 and \$20,732 at December 31, 2005 and 2004, respectively. This represents approximately 4% of the loan portfolio at December 31, 2005 and December 31, 2004.

The Company has established operating policies relating to the credit process and collateral in loan originations. Loans to purchase real and personal property are generally collateralized by the related property and with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of collateral and the evaluation of the creditworthiness of the individual borrower or project based on available financial information. Management considers the concentration of credit risk to be minimal.

Note 16: Fair Value of Financial Instruments and Interest Rate Risk

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the fair discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments: Cash and Due from Banks, Interest-Bearing Deposits, and Federal Funds Sold

The carrying amounts approximate fair value.
Securities

The fair values of securities, excluding restricted stock, are determined by quoted market prices or dealer quotes. The fair value of certain state and municipal securities is not readily available through market sources other than dealer quotations, so fair value estimates are based on quoted market prices of similar instruments adjusted for differences between the quoted instruments and the instruments being valued. The carrying value of restricted securities approximates fair value based upon the redemption provisions of the applicable entities.

Loans Held for Sale

Fair values of loans held for sale are based on commitments on hand from investors or prevailing market prices.

Loans

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Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate - commercial, real estate - construction, real estate - mortgage, credit card and other consumer loans. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan, as well as estimates for prepayments. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified, as required, by an estimate of the effect of economic conditions on lending.

55

Fair value for significant nonperforming loans is based on estimated cash flows which are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

Deposits

The fair value of demand and savings deposits is the amount payable on demand. The fair value of fixed maturity term deposits and certificates of deposit is estimated using the rates currently offered for deposits with similar remaining maturities.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Other Borrowed Funds

Other borrowed funds, represents treasury tax and loan deposits, and short-term borrowings from the Federal Home Loan Bank. The carrying amount is a reasonable estimate of fair value because the deposits are generally repaid within 120 days from the transaction date.

Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are not deemed significant at December 31, 2005 and 2004, and as such, the related fair values have not been estimated.

The estimated fair values, and related carrying amounts, of the Company's financial instruments are as follows:

| | December 31, | | | |
|-------------------------------|--------------------|-------------------------|--------------------|-------------------------|
| | 2005 | | 2004 | |
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and due from banks | \$ 20,115 | \$ 20,115 | \$ 12,493 | \$ 12,493 |
| Interest-bearing deposits | 10,279 | 10,279 | 22,463 | 22,463 |
| Securities | 272,541 | 272,346 | 250,708 | 253,020 |
| Mortgage loans held for sale | --- | --- | 1,003 | 1,003 |
| Loans, net | 487,162 | 485,284 | 472,199 | 471,993 |
| Accrued interest receivable | 5,145 | 5,145 | 4,870 | 4,870 |
| Financial liabilities: | | | | |
| Deposits | \$ 745,649 | \$ 745,789 | \$ 705,932 | \$ 710,503 |
| Other borrowed funds | 357 | 357 | 297 | 297 |
| Accrued interest payable | 725 | 725 | 483 | 483 |

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Note 17: Selected Quarterly Data (Unaudited)

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2005 and 2004:

| | 2005 | | | |
|------------------------------------|------------------|----------------|------------------|-------------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Income Statement Data: | | | | |
| Interest income | \$ 11,035 | \$ 11,268 | \$ 11,483 | \$ 11,594 |
| Interest expense | 3,043 | 3,226 | 3,816 | 4,095 |
| | ----- | ----- | ----- | ----- |
| Net interest income | 7,992 | 8,042 | 7,667 | 7,499 |
| Provision for loan losses | 190 | 198 | 169 | 10 |
| Noninterest income | 1,768 | 1,927 | 1,892 | 2,026 |
| Noninterest expense | 5,689 | 5,591 | 5,379 | 5,239 |
| Income taxes | 888 | 1,028 | 957 | 1,051 |
| | ----- | ----- | ----- | ----- |
| Net income | \$ 2,993 | \$ 3,152 | \$ 3,054 | \$ 3,225 |
| | ===== | ===== | ===== | ===== |
| Per Share Data: | | | | |
| ----- | | | | |
| Basic net income per share | \$ 0.85 | \$ 0.90 | \$ 0.87 | \$ 0.92 |
| Fully diluted net income per share | 0.85 | 0.89 | 0.86 | 0.92 |
| Cash dividends per share | --- | 0.70 | --- | 0.72 |
| Book value per share | 25.22 | 25.60 | 26.39 | 26.19 |

56

| | 2004 | | | |
|------------------------------------|------------------|-------------------|------------------|-------------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Income Statement Data: | | | | |
| Interest income | \$ 9,797 | \$ 10,017 | \$ 10,841 | \$ 10,837 |
| Interest expense | 2,599 | 2,659 | 2,904 | 2,963 |
| | ----- | ----- | ----- | ----- |
| Net interest income | 7,198 | 7,358 | 7,937 | 7,874 |
| Provision for loan losses | 288 | 304 | 293 | 304 |
| Noninterest income | 1,739 | 1,681 | 1,865 | 1,857 |
| Noninterest expense | 4,820 | 4,915 | 5,275 | 5,326 |
| Income taxes | 869 | 884 | 1,019 | 982 |
| | ----- | ----- | ----- | ----- |
| Net income | \$ 2,960 | \$ 2,936 | \$ 3,215 | \$ 3,119 |
| | ===== | ===== | ===== | ===== |
| Per Share Data: | | | | |
| ----- | | | | |
| Basic net income per share | \$ 0.84 | \$ 0.84 | \$ 0.91 | \$ 0.89 |
| Fully diluted net income per share | 0.84 | 0.83 | 0.91 | 0.88 |
| Cash dividends per share | --- | 0.63 | --- | 0.65 |

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| | | | | |
|----------------------|-------|-------|-------|-------|
| Book value per share | 24.11 | 23.12 | 24.82 | 24.75 |
|----------------------|-------|-------|-------|-------|

57

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
National Bankshares, Inc.
Blacksburg, Virginia

We have audited the accompanying consolidated balance sheets of National Bankshares, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that National Bankshares, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). National Bankshares, Inc. and subsidiaries' management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's

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assets that could have a material effect on the financial statements.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of National Bankshares, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that National Bankshares, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, is fairly

58

stated, in all material respects, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, National Bankshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

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

Winchester, Virginia
February 9, 2006

59

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

Under the supervision and with the participation of management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this annual report. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are our controls and procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and

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principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

Management's Report on Internal Control Over Financial Reporting.

To the Stockholders
National Bankshares, Inc.

Management is responsible for the preparation and fair presentation of the financial statements included in this annual report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management's judgments and estimates concerning effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting includes those policies and procedures that pertain to the Company's ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the Company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2005. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management believes the Company maintained effective internal control over financial reporting as of December 31, 2005.

The Board of Directors, acting through its Audit committee, is responsible for the oversight of the Company's accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent auditor and approves decisions regarding the appointment or removal of the Company Auditor. It meets periodically with management, the independent auditors and the internal auditors to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the Company in addition to reviewing the Company's financial reports. The independent auditors and the internal auditors have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee.

Yount, Hyde & Barbour, P.C., independent auditors of the Company's financial statements, has attested to management's assertion with respect to the effectiveness of the Company's internal control over financial reporting as of December 31, 2005.

/s/JAMES G. RAKES

/s/ J. ROBERT BUCHANAN

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Chairman, President and
Chief Executive Officer

Treasurer and
Chief Financial Officer

60

Item 9B. Other Information

Not Applicable

Part III

Item 10. Directors and Executive Officers of the Registrant

Information with respect to the directors of Bankshares is set out under the caption "Election of Directors" on pages 2 through 3 of Bankshares' Proxy Statement dated March 14, 2006 which information is incorporated herein by reference.

The Board of Directors of Bankshares has a standing audit committee made up entirely of independent directors, as that term is defined in the Nasdaq Stock Market Rules. Dr. J. R. Stewart chairs the Audit Committee and its members are Mr. P. A. Duncan, Mr. J. H. Harry and Dr. J. M. Lewis. Each member of the Audit Committee has extensive business experience; however, the Committee has identified Dr. Lewis as its financial expert, since he has a professional background which involves financial oversight responsibilities. Dr. Lewis currently oversees the preparation of financial statements in his role as President of New River Community College. He previously served as the College's Chief Financial Officer.

The Company and each of its subsidiaries have adopted Codes of Ethics for directors, officers and employees, specifically including the Chief Executive Officer and Chief Financial Officer of Bankshares. These Codes of Ethics are available on the Company's web site at www.nationalbankshares.com.

The following is a list of names and ages of all executive officers of Bankshares; their terms of office as officers; the positions and offices within Bankshares held by each officer; and each person's principal occupation or employment during the past five years.

| Name | Age | Offices and Positions Held | Year Elected as Officer/Director |
|--------------------|-----|--|----------------------------------|
| James G. Rakes | 61 | Chairman, President and Chief Executive Officer, National Bankshares, Inc.; President and Chief Executive Officer of The National Bank of Blacksburg since 1983 and Chairman since 2005. Chairman, President and Treasurer of National Bankshares Financial Services, Inc. since 2001. | 1986 |
| J. Robert Buchanan | 54 | Treasurer, National Bankshares, Inc.; Executive Vice President/Chief Operating Officer and Secretary of Bank of Tazewell County since 2003; prior thereto Cashier and Senior Vice President/Chief Financial Officer of The National Bank of Blacksburg since 1998. | 1998 |
| Marilyn B. Buhyoff | 57 | Secretary & Counsel, National Bankshares, | 1989 |

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Inc.; Counsel of The National Bank of Blacksburg since 1989, Trust Officer since 2004, and prior thereto Senior Vice President/ Administration, since 1992. Secretary of National Bankshares Financial Services, Inc. since 2001, and Executive Vice President since 2004.

| | | | |
|-----------------|----|---|------|
| F. Brad Denardo | 53 | Corporate Officer, National Bankshares, Inc.; Executive Vice President/Chief Operating Officer of The National Bank of Blacksburg since 2002; prior thereto Executive Vice President/Loans of The National Bank of Blacksburg since 1989. | 1989 |
|-----------------|----|---|------|

Item 11. Executive Compensation

The information set forth under "Executive Compensation" on pages 5 through 6 of Bankshares' Proxy Statement dated March 14, 2006 is incorporated herein by reference.

61

Item 12. Security Ownership of Certain Beneficial Owners and Management And Related Stockholder Matters

The information contained under "Stock Ownership of Directors and Executive Officers" on pages 1 and 2 of Bankshares' Proxy Statement dated March 14, 2006 for the Annual Meeting of Stockholders to be held April 11, 2006 is incorporated herein by reference.

The following table summarizes information concerning National Bankshares equity compensation plans at December 31, 2005:

| Plan Category | Number of Shares to be Issued upon Exercise of Outstanding Options and Warrants | Weighted Average Exercise Price of Outstanding Options and Warrants | Number of Shares Remaining Available for Future Issuance Under Equity Compensation (Excluding Shares Reflected in Column) |
|--|---|---|---|
| Equity compensation plans approved by shareholders-1999 Stock Incentive Plan | 86,250 | \$ 39.81 | 1 |
| Equity compensation plans not approved by shareholders | --- | --- | --- |
| Total | 86,250 | \$ 39.81 | 1 |

Item 13. Certain Relationships and Related Transactions

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The information contained under "Certain Transactions With Officers and Directors" on page 14 of Bankshares' Proxy Statement dated March 14, 2006 is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The following fees were paid to Yount, Hyde & Barbour, P.C., Certified Public Accountants, for services provided to Bankshares for the years ended December 31, 2005 and 2004. The Audit Committee determined that the provision of non-audit services by Yount, Hyde & Barbour P.C. did not compromise the firm's ability to maintain its independence.

| Principal Accounting Fees and Services | | | | |
|--|-----------|------------|-----------|------------|
| | 2005 | | 2004 | |
| | Fees | Percentage | Fees | Percentage |
| Audit fees | \$89,400 | 78% | \$85,625 | 74% |
| Audit-related fees | 18,348 | 16% | 25,956 | 22% |
| Tax fees | 7,350 | 6% | 4,800 | 4% |
| | \$115,098 | 100% | \$116,381 | 100% |

Audit fees: Audit and review services and review of documents filed with the SEC.

Audit-related fees: Employee benefit plan audits, accounting assistance with acquisitions and consultation concerning financial accounting and reporting standards.

Tax fees: Preparation of federal and state tax returns, review of quarterly estimated tax payments and consultation concerning tax compliance issues.

The Audit Committee of the Board of Directors meets in advance and specifically approves of the provision of all services of Yount, Hyde & Barbour, P.C.

62

Part IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Financial Statements

The following consolidated financial statements of National Bankshares, Inc. are included in Item 8: Report of Independent Registered Public Accounting Firm Consolidated Balance Sheets - As of December 31, 2005 and 2004 Consolidated Statements of Income - Years ended December 31, 2005, 2004 and 2003 Consolidated Statements of Changes in Stockholders Equity - Years ended December 31, 2005, 2004 and 2003 Consolidated Statements of Cash Flows - Years ended December 31, 2005, 2004 and 2003 Notes to Consolidated Financial Statements

(a) (2) Financial Statement Schedules

Certain schedules to the consolidated financial statements have been omitted if they were not required by Article 9 of Regulation S-X or if, under the related instructions, they were inapplicable, or if the information is contained elsewhere in this Annual Report on Form 10-K.

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(a) (3) Exhibits

A list of the exhibits filed or incorporated in this Annual Report by reference is as follows:

| | | |
|--------------|--|---|
| 3(i) | Articles of Incorporation, as amended, of National Bankshares, Inc. | (incorporated herein Exhibit 3(a) of the Form 10K for fiscal December 31, 1993) |
| 3(i) | Articles of Amendment to Articles of Incorporation of National Bankshares, Inc., dated April 8, 2003. | (incorporated herein to Exhibit 3(i) of t Report on Form 10K f ended December 31, 2 |
| 4(i) | Specimen copy of certificate for National Bankshares, Inc. common stock, \$2.50 par value | (incorporated herein to Exhibit 4(a) of t Report on Form 10K f ended December 31, 1 |
| 4(i) | Article Four of the Articles of Incorporation of National Bankshares, Inc. included in Exhibit No. 3(a) | (incorporated herein Exhibit 4(b) of the Form 10K for fiscal December 31, 1993) |
| 10(ii) (B) | Computer software license agreement dated June 18, 1990, by and between Information Technology, Inc. and The National Bank of Blacksburg | (incorporated herein Exhibit 10(e) of th on Form 10K for fisco December 31, 1992) |
| *10(iii) (A) | National Bankshares, Inc. 1999 Stock Option Plan | (incorporated herein to Exhibit 4.3 of th filed as Registratio with the Commission |
| *10(iii) (A) | Employment Agreement dated January 2002 between National Bankshares, Inc. and James G. Rakes | (incorporated herein to Exhibit 10(iii) (A) for the period ended |
| *10(iii) (A) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg | (incorporated herein to Exhibit 10 (iii) for the period ended 2002) |
| *10(iii) (A) | Change in Control Agreement dated January 5, 2003, between National Bankshares, Inc. and Marilyn B. Buhyoff | (incorporated herein to Exhibit 10 (iii) for the period ended 2002) |
| *10(iii) (A) | Change in Control Agreement dated January 8, 2003, between National Bankshares, Inc. and F. Brad Denardo | (incorporated herein to Exhibit 10 (iii) for the period ended 2002) |
| +21(i) | Subsidiaries of National Bankshares, Inc. | Page 70 |

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| | | |
|---------|--|---------|
| +23 | Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8. | Page 71 |
| +31(i) | Section 906 Certification of Chief Executive Officer | Page 65 |
| +31(ii) | Section 906 Certification of Chief Financial Officer | Page 66 |
| +32(i) | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | Page 68 |
| +32(ii) | 18 U.S.C. Section 1350 Certification of Chief Financial Officer | Page 68 |

*Indicates a management contract or compensatory plan required to be filed herein. +Filed with this Annual Report on Form 10-K.

Signatures

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

NATIONAL BANKSHARES, INC.

/s/ JAMES G. RAKES

James G. Rakes
Chairman, President & Chief Executive Office
(Principal Executive Officer)

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Treasurer
(Principal Financial Officer)

64

Exhibit No. 31(i)

CERTIFICATIONS UNDER SECTION 906 OF THE SARBANES OXLEY ACT OF 2002

I, James G. Rakes, Chairman, President and Chief Executive Officer of National Bankshares, Inc., certify that:

1. I have reviewed this annual report on Form 10-K of National Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

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4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a - 15 (e) and 15d - 15 (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a - 15(f) and 15d - 15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2006

/s/ JAMES G. RAKES

James G. Rakes
Chairman
President and Chief Executive Officer
(Principal Executive Officer)

Exhibit 31(ii)

I, J. Robert Buchanan, Treasurer (Chief Financial Officer) of National Bankshares, Inc., certify that:

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1. I have reviewed this annual report on Form 10-K of National Bankshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a - 15 (e) and 15d - 15 (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a - 15(f) and 15d - 15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purpose in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2006

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Treasurer
(Principal Financial Officer)

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Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

| Name ----- | Date ----- | Title ----- |
|---|---------------------|---|
| /s/ L. A. BOWMAN ----- L. A. Bowman | 03/08/2006 ----- | Director |
| /s/ P. A. DUNCAN ----- P. A. Duncan | 03/08/2006 ----- | Director |
| /s/ J. H. HARRY ----- J. H. Harry | 03/08/2006 ----- | Director |
| /s/ J. M. LEWIS ----- J. M. Lewis | 03/08/2006 ----- | Director |
| /s/ M. G. MILLER ----- M. G. Miller | 03/08/2006 ----- | Director |
| /s/ W. A. PEERY ----- W. A. Peery | 03/08/2006 ----- | Director |
| /s/ J. G. RAKES ----- J. G. Rakes | 03/08/2006 ----- | Chairman of the Board President and Chief Executive Officer - National Bankshares, Inc. |
| /s/ J. M. SHULER ----- J. M. Shuler | 03/08/2006 ----- | Director |
| /s/ J. R. STEWART ----- J. R. Stewart | 03/08/2006 ----- | Director |

67

Exhibit 32(i)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

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PURSUANT TO U.S.C. SECTION 1350

In connection with the Form 10-K of National Bankshares, Inc. for the year ended December 31, 2005, I, James G. Rakes, Chairman, President and Chief Executive Officer of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief that:

- (1) such Form 10-K for the year ended December 31, 2005, fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and
- (2) the information contained in such Form 10-K for the year ended December 31, 2005, fairly presents in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ JAMES G. RAKES

James G. Rakes
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

Exhibit 32(ii)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO U.S.C. SECTION 1350

In connection with the Form 10-K of National Bankshares, Inc. for the year ended December 31, 2005, I, J. Robert Buchanan, Treasurer of National Bankshares, Inc., hereby certify pursuant to 18 U. S. C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief that:

- (1) such Form 10-K for the year ended December 31, 2005, fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and
- (2) the information contained in such Form 10-K for the year ended December 31, 2005, fairly presents in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Treasurer
(Principal Financial Officer)

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Index of Exhibits

The following exhibits are filed with this Annual Report on Form 10-K.

| | | |
|--------|--|---------|
| 21(i) | Subsidiaries of National Bankshares, Inc. | Page 70 |
| 23 | Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8. | Page 71 |
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| 32(i) | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | Page 68 |
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Exhibit No. 21(i)

SUBSIDIARIES
OF
NATIONAL BANKSHARES, INC.

National Bankshares, Inc.

