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NATIONAL BANKSHARES INC
Form 10-Q
May 10, 2006

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

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934 For the
Quarterly Period Ended March 31, 2006.

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OR 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 54-1375874
(State of incorporation) (I.R.S. Employer Identification No.)

101 Hubbard Street
P.O. Box 90002
Blacksburg, VA 24062-9002
(540) 951-6300
(Address and telephone number of principal executive offices)

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

Indicate by check mark whether the registrant 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.

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 Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 30, 2006
-----	-----
Common Stock, \$1.25 Par Value	7,013,784

(This report contains 31 pages)

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NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q

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Part I Financial Information Item 1. Financial Statements

National Bankshares, Inc. and Subsidiaries Consolidated Balance Sheets

(\$ In thousands, except share and per share data)	(Unaudited) March 31, 2006 =====	Decem 2 =====
Assets		
Cash and due from banks	\$18,270	
Interest-bearing deposits	17,253	
Securities available for sale, at fair value	168,560	
Securities held to maturity (fair value approximates \$106,574 at March 31, 2006 and \$109,513 at December 31, 2005)	107,268	
Mortgage loans held for sale	493	
Loans:		
Real estate construction loans	27,290	
Real estate mortgage loans	117,326	
Commercial and industrial loans	264,300	
Loans to individuals	81,841	
Total loans	490,757	
Less unearned income and deferred fees	(948)	
Loans, net of unearned income and deferred fees	489,809	
Less: allowance for loan losses	(5,418)	
Loans, net	484,391	
Bank premises and equipment, net	12,757	
Accrued interest receivable	5,498	
Other real estate owned, net	390	
Intangible assets and goodwill, net	16,829	
Other assets	16,247	
Total assets	\$847,956 =====	\$ =====
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	\$117,895	\$
Interest-bearing demand deposits	225,240	
Savings deposits	55,210	
Time deposits	350,877	

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	-----	-----
Total deposits	749,222	
	-----	-----
Other borrowed funds	83	
Accrued interest payable	724	
Other liabilities	3,667	
	-----	-----
Total liabilities	753,696	
	-----	-----
3		
Stockholders' Equity Preferred stock of no par value.		
Authorized 5,000,000 shares; none issued and outstanding	---	
Common stock of \$1.25 par value.		
Authorized 10,000,000 shares; issued and outstanding 7,013,174 shares in 2006 and 7,019,874 in 2005	8,767	
Retained earnings	87,407	
Accumulated other comprehensive income (loss), net	(1,914)	
	-----	-----
Total stockholders' equity	94,260	
	-----	-----
Total liabilities and stockholders' equity	\$847,956	\$
	=====	=====

See accompanying notes to the consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
Three Months Ended March 31, 2006 and 2005
(Unaudited)

	March 31,	
(\$ In thousands, except share and per share data)	2006	
=====	=====	=====
Interest income:		
Interest and fees on loans	\$8,361	
Interest on interest-bearing deposits	158	
Interest on securities - taxable	1,803	
Interest on securities - nontaxable	1,261	
	-----	-----
Total interest income	11,583	
	-----	-----
Interest expense:		

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Interest on time deposits \$100,000 or more	1,088	
Interest on other deposits	3,148	
Interest on borrowed funds	2	
	-----	----
Total interest expense	4,238	
	-----	----
Net interest income	7,345	
Provision for loan losses	17	
	-----	----
Net interest income after provision for loan losses	7,328	
	-----	----
Noninterest income:		
Service charges on deposit accounts	815	
Other service charges and fees	109	
Credit card fees	524	
Trust income	380	
Other income	267	
Realized securities (losses), net	(36)	
	-----	----
Total noninterest income	2,059	
	-----	----
Noninterest expense:		
Salaries and employee benefits	2,911	
Occupancy, furniture and fixtures	533	
Data processing and ATM	301	
Credit card processing	413	
Intangibles amortization	284	
Net costs of other real estate owned	14	
Other operating expenses	1,043	
	-----	----
Total noninterest expense	5,499	
	-----	----
Income before income tax expense	3,888	
Income tax expense	885	
	-----	----
Net income	\$3,003	
	=====	=====

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Net income per share - basic	\$0.43	
	=====	=====
- diluted	\$0.43	
	=====	=====
Weighted average number of common shares outstanding - basic	7,015,061	
	=====	=====
- diluted	7,044,385	
	=====	=====
Dividends declared per share	\$---	
	=====	=====

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries Consolidated Statements of Changes in Stockholders' Equity Three Months Ended March 31, 2006 and 2005 (Unaudited)

(\$ In thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income
	=====	=====	=====	=====
Balances, December 31, 2004	\$8,797	\$77,735	\$556	
Net income	---	2,993	---	2,993
Other comprehensive loss, net of tax:				
Unrealized loss on securities available for sale, net of income tax \$(730)	---	---	---	(1,335)
Reclass adjustment, net of tax \$12	---	---	---	
Other comprehensive loss	---	---	(1,335)	(1,335)
Comprehensive income	---	---	---	\$1,658
Exercise of stock options	5	42	---	
Balances, March 31, 2005	\$8,802	\$80,770	\$ (779)	
	=====	=====	=====	=====
Balances, December 31, 2005	\$8,775	\$84,610	\$ (1,446)	
Net income	---	3,003	---	3,003
Other comprehensive loss, net of tax:				
Unrealized losses on securities available for sale, net of income tax \$(265)	---	---	---	(468)
Reclass adjustment, net of income tax \$13	---	---	---	
Other comprehensive loss	---	---	(468)	(468)
Comprehensive income	---	---	---	\$2,535
Exercise of stock options	5	36	---	
Stock repurchase	(13)	(242)		
Balances, March 31, 2006	\$8,767	\$87,407	\$ (1,914)	
	=====	=====	=====	=====

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See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries Consolidated Statements of Cash Flows Three Months Ended March 31, 2006 and 2005 (Unaudited)

	March 31, 2006
(\$In thousands)	
Cash flows from operating activities:	
Net income	\$3,003
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	17
Depreciation of bank premises and equipment	246
Amortization of intangibles	284
Amortization of premiums and accretion of discount, net	61
(Gains) on disposal of fixed assets	(2)
(Gains) losses on sales and calls of securities available for sale, net	36
(Gains) on calls of securities held to maturity	---
Losses and writedowns on other real estate owned	10
(Increase) decrease in:	
Mortgage loans held for sale	(493)
Accrued interest receivable	(353)
Other assets	(36)
Increase (decrease) in:	
Accrued interest payable	(1)
Other liabilities	839
Net cash provided by operating activities	\$3,611
Cash flows from investing activities	
Net (increase) decrease in interest-bearing deposits	\$ (6,974)
Proceeds from calls, principal payments, sales and maturities of securities available for sale	4,156
Proceeds from calls, principal payments and maturities of securities held to maturity	3,880
Purchases of securities available for sale	(10,682)
Purchases of securities held to maturity	(1,458)
Purchases of loan participations	---
Collections of loan participations	(1,398)
Net (increase) decrease in loans to customers	4,089
Proceeds from disposal of other real estate owned	---
Recoveries on loans charged off	39
Purchase of bank premises and equipment	(196)
Proceeds from disposal of bank premises and equipment	3
Net cash (used in) investing activities	\$ (8,541)

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Cash flows from financing activities:	
Net increase in other deposits	\$5,784
Net increase (decrease) in time deposits	(2,211)
Net increase (decrease) in other borrowed funds	(274)
Stock options exercised	41
Stock repurchased	(255)

Net cash provided by financing activities	\$3,085

Net increase (decrease) in cash and due from banks	(1,845)
Cash and due from banks at beginning of period	20,115

Cash and due from banks at end of period	\$18,270
	=====
Supplemental disclosure of cash flow information:	
Cash paid for interest	\$4,239
	=====
Cash paid for income taxes	\$---
	=====
Loans charged to the allowance for loan losses	\$87
	=====
Loans transferred to other real estate owned	\$24
	=====
Unrealized (losses) on securities available for sale	\$(720)
	=====
Transactions related to acquisition of branches	
Increase in assets and liabilities:	
Loans	\$---
Deposits	\$---
Fixed Assets	\$---

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries Notes to Consolidated Financial Statements March 31, 2006 (Unaudited)

(\$ In thousands, except share and per share data)

Note (1)

The consolidated financial statements 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), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of

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results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company's 2005 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at www.nationalbankshares.com.

Note (2) Stock-Based Compensation

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 142,000 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 March 31, 2006, there were 286,000 additional shares available for grant under the plan.

Compensation expense is calculated using the Black-Scholes model and is amortized over the requisite service period using the straight-line method. Please refer to the Company's Form 10-K dated December 31, 2005 for assumptions used. There have been no grants of stock options in 2006.

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Options	Shares (1)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at January 1, 2006	172,500	\$19.90		
Granted	---			
Exercised	(4,000)	\$10.45		
Forfeited or expired	---			

Outstanding at March 31, 2006	168,500	\$20.13	7.7	\$824

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	=====	=====	=====	=====
Exercisable at March 31, 2006	168,500	\$20.134	7.7	\$824
	=====	=====	=====	=====

1. Outstanding shares at January 1, 2006 have been adjusted to reflect a 2-for-1 stock split effective March 31, 2006.

Because no options were granted in 2006, there is no expense included in net income.

	Three months ended March 31, ----- 2005 -----
(\$ In thousands, except per share data)	
Net income, as reported	\$2,993
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(36)
Pro forma net income	\$2,957
Earnings per share:	
Basic - as reported	\$0.43
Basic - pro forma	\$0.42
Diluted - as reported	\$0.43
Diluted - pro forma	\$0.42
-----	-----

During the three months ended March 31, 2006, there were no stock options granted and 4,000 stock options were exercised with an intrinsic value of \$54,000. For the three months ended March 31, 2005 there were no stock options granted and 1,750 options were exercised.

For and 2004, 36,000 shares and 16,500 shares were excluded.

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Note (3) Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

	For the periods ended		
	March 31, ----- 2006	March 31, ----- 2005	December 31, ----- 2005
(\$ In thousands, except % data)			
Balance at beginning of period	\$5,449	\$5,729	\$5,729
Provision for loan losses	17	190	567

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Loans charged off	(87)	(253)	(1,101)
Recoveries	39	46	254
Balance at the end of period	\$5,418	\$5,712	\$5,449
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees	1.11%	1.16%	1.11%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees(1.)	0.04%	0.17%	0.17%
Ratio of allowance for loan losses to nonperforming loans(2.)	5,889.13%	1,646.11%	3,061.24%

1. Net charge-offs are on an annualized basis.
2. The Company defines nonperforming loans as total nonaccrual and restructured loans. Loans 90 days past due and still accruing are excluded.

	March 31, ----- 2006	2005	December 31, ----- 2005
(\$ In thousands, except % data)			
Nonperforming Assets:			
Nonaccrual loans	\$92	\$347	\$178
Restructured loans	---	---	---
Total nonperforming loans	92	347	178
Foreclosed property	390	715	376
Total nonperforming assets	\$482	\$1,062	\$554
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	0.10%	0.21%	0.11%

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	March 31, ----- 2006	2005	December 31, ----- 2005
Loans Past due 90 days or more and still accruing	\$184	\$763	\$546
Ratio of loans past due 90 days or			

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more and still accruing to loans, net of unearned income and deferred fees	0.04%	0.15%	0.11%
	=====	=====	=====
Impaired loans:			
Total impaired loans	\$92	\$341	\$174
	=====	=====	=====
Impaired loans with a valuation allowance	---	---	---
Valuation allowance	---	---	---
	-----	-----	-----
Impaired loans, net of allowance	---	---	---
	=====	=====	=====
Impaired loans with no valuation allowance	\$92	\$341	\$174
	=====	=====	=====
Average recorded investment in impaired loans	\$133	\$348	\$274
	=====	=====	=====
Income recognized on impaired loans	\$2	---	---
	=====	=====	=====
Amount of income recognized on a cash basis	\$2	---	\$11
	=====	=====	=====

Nonaccrual loans excluded from impaired loan disclosure under FASB 114 at March 31, 2006 were \$0.

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Note (4) Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for the sale by major security type as of March 31, 2006 are as follows:

	March 31, 2006		
(\$ In thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses
	-----	-----	-----
Available for sale:			
U.S. Treasury	\$3,036	---	\$161
U.S. Government Agencies and Corporations	28,767	---	395
State and political subdivisions	72,739	965	726
Mortgage-backed securities	30,542	79	545
Corporate debt securities	32,071	72	1,441
Federal Reserve Bank stock- restricted	208	---	---

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Federal Home Loan			
Bank stock-restricted	1,759	---	---
Other securities	1,433	157	---
	-----	-----	-----
Total securities available for sale	\$170,555	\$1,273	\$3,268
	=====	=====	=====

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type as of March 31, 2006 are as follows:

	March 31, 2006		
(\$ In thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses
	-----	-----	-----
Held to Maturity:			
U.S. Government Agencies and Corporations	\$28,606	---	\$825
State and political subdivisions	54,674	832	293
Mortgage-backed securities	3,785	41	44
Corporate securities	20,203	236	641
	-----	-----	-----
Total securities held to maturity	\$107,268	\$1,109	\$1,803
	=====	=====	=====

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Information pertaining to securities with gross unrealized losses at March 31, 2006 and December 31, 2005, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	March 31, 2006			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Government agencies and corporations	\$40,447	\$587	\$19,641	\$
State and political subdivisions	26,722	345	18,265	
Mortgage-backed securities	18,301	252	10,437	
Corporate debt securities	10,178	276	27,329	1,
	-----	---	-----	--
Total temporarily impaired securities	\$95,648	\$1,460	\$75,672	\$3,
	=====	=====	=====	=====

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	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	
State and political subdivisions	28,660	429	15,625	
Mortgage-backed securities	22,169	333	3,132	
Corporate debt securities	12,052	200	25,881	1,
	-----	---	-----	---
Total temporarily impaired securities	\$101,794	\$1,503	\$56,336	\$2,
	=====	=====	=====	=====

The Company had 260 securities with a fair value of \$171,320 which were temporarily impaired at March 31, 2006. The total unrealized loss on these securities was \$5,071. 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 considered temporary at March 31, 2006. All securities shown are above investment grade.

Note (5) Recent Accounting Pronouncements

In March 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets an amendment of FASB Statement 140" (Statement 156). Statement 156 amends Statement 140 with respect to separately recognized servicing assets and liabilities. Statement 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract and requires all servicing assets and liabilities to be initially measured at fair value, if practicable. Statement 156 also permits entities to subsequently measure servicing assets and liabilities using an amortization method or fair value measurement method. Under the amortization method, servicing assets and liabilities are amortized in proportion to and over the estimated period of servicing. Under the fair value measurement method, servicing assets are measured at fair value at each reporting date and changes in fair value are reported in net income for the period the change occurs.

Adoption of Statement 156 is required as of the beginning of fiscal years beginning subsequent to September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements.

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The Corporation does not expect the adoption of Statement 156 at the beginning of 2007 to have a material impact.

Note (6) Defined Benefit Plan

Components of Net Periodic Benefit Cost

Pension Benefits

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	Three Months Ended March 31,	
(\$ in Thousands)	2006	2005
Service cost	\$ 143	\$ 140
Interest cost	161	153
Expected return on plan assets	(143)	(145)
Amortization of prior service cost	(3)	2
Recognized net actuarial loss	53	46
Amortization of transition cost	2	(3)
Net periodic benefit cost	\$ 213	\$ 193

Employer Contributions

Bankshares expects to contribute a total of \$698, paid in quarterly installments, to the pension plan for 2006. Bankshares anticipates making all required contributions prior to the end of 2006.

Note (7) Stock Split

Bankshares' Board of Directors approved a 2-for-1 stock split of Bankshares' common stock. All per share information for all periods presented has been retroactively restated to reflect the stock split.

National Bankshares, Inc. and Subsidiaries (In thousands, except per share data)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations for the Three Months Ended March 31, 2006

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 (the Company), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Refer to the financial statements and other information included in this report as well as the 2005 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

This Quarterly Report on Form 10-Q contains forward-looking statements as described in 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,

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historical loss factors as one element in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

Allowance for 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 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 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 actual events occur. The formula allowance uses a historical loss view and certain qualitative factors 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. Expected cash flows and fair market value of collateral are used to estimate these losses. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors, whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Core deposit intangibles

Effective January 1, 2002, the Corporation 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

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of a business, and therefore will continue to be amortized.

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Overview

National Bankshares, Inc. (NBI) is a financial holding company located in Southwest Virginia. It conducts operations primarily through two full-service banking affiliates, the National Bank of Blacksburg and Bank of Tazewell County. It also has one nonbanking affiliate, National Bankshares Financial Services, Inc., which offers investment and insurance products. Net income derived from the nonbanking affiliate is not significant at this time or in the foreseeable future. NBI is a community bank operation.

Performance Summary

The following table shows NBI's key performance ratios for the period ended March 31, 2006 and December 31, 2005 and 2004. Per share data has been adjusted to reflect the effects of the March 31, 2006 2-for-1 stock split.

	March 31, 2006	December 31, 2005	D
Return on average assets	1.45%	1.52%	
Return on average equity	13.04%	13.73%	
Net interest margin (1)	4.22%	4.45%	
Noninterest margin (2)	1.64%	1.74%	
Basic net earnings per share	\$0.43	\$1.77	
Fully diluted net earnings per share	\$0.43	\$1.76	

- (1) Net Interest Margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets using a tax rate of 35%.
- (2) Noninterest Margin: Noninterest income (including securities gains and losses) less noninterest expense (excluding the provision for bad debts and income taxes) divided by average year-to-date assets. This is a non-GAAP financial measure of the level of noninterest income and expense.

The return on average assets for the first quarter of 2006 was 1.45%, down slightly from the 1.51% for the same period in the prior year. The return on average equity also experienced a decline.

The net interest margin declined by 49 basis points. This decrease was due to rising interest rates. Interest expense has continued to grow at a faster pace than interest income.

Growth

The following table shows NBI's key growth indicators:

March 31, 2006	December 31, 2005	December 31, 2004
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Securities	\$275,828	\$272,541	\$250,708
Loans, net	484,391	487,162	472,199
Deposits	749,222	745,649	705,932
Total assets	847,956	841,498	796,154

At March 31, 2006 total assets were \$847,956, an increase of \$6,458 or 0.77%. If annualized, the growth rate would be approximately 3.1%.

In order to reduce the compression of the net interest margin, management has exercised restraint when pricing large denomination time deposits. This approach has had positive influence on profitability; however, it has caused lower rates of deposit growth.

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Asset Quality

Key asset quality indicators are shown below:

	March 31, 2006	December 31, 2005	December 31, 2004
Nonperforming loans	\$ 92	\$ 178	\$ 178
Loans past due over 90 days	184	546	546
Other real estate owned	390	376	376
Allowance for loan losses to loans	1.11%	1.11%	1.11%
Net charge-off ratio	0.04%	0.17%	0.17%

This data indicates that the level of nonperforming loans has declined, as has the level of loans past due 90 days or more. Other real estate owned continues to decline as properties foreclosed upon are sold. Asset quality remains excellent.

Net Interest Income

Net interest income for the period ending March 31, 2006 was \$7,345, a decrease of \$647 or 8.1%.

The principal cause of the decline is rising interest rates. Specifically, the Company's interest-bearing liabilities have repriced upward at a faster pace than interest-earning assets. During the period the yield on earning assets rose by 7 basis points, while the cost of interest-bearing liabilities increased by 56 basis points.

Net Interest Income - Trends and Future Expectations

During 2005, the Federal Reserve Board initiated a series of interest

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rate increases. These increases were designed to restore interest rates to historically more typical levels and to prevent inflation. Rate increases have occurred at regular intervals, each at 25 basis points to date.

Rising energy costs coupled with high levels of government spending are viewed as inflationary. Government expenditures are expected to remain high as a result of natural disasters, conflict in the Middle East and new spending programs such as the prescription drug benefit for senior citizens. The Federal Reserve Bank may yet raise interest rates to combat inflationary pressures. However, there is a general expectation that interest rates are at or near their peak. Once interest rates stabilize, the compression of the net interest margin should begin to abate which would have a positive effect on the level of net interest income.

The general impact of a rising interest rate scenario on the Company's balance sheet is described on page 15 of the Company's 2005 Form 10K, which is incorporated by reference in this report.

Interest Expense

Interest expense for the three months ended March 31, 2006 was \$4,238, an increase of \$1,195, or 39.3%, from the same period the prior year. As previously discussed, rising interest rates have been the major contributor to this increase.

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.

Provision and Allowance for Loan Losses

The provision for loan losses for the three-month period ended March 31, 2006 was \$17, a \$173 decrease from the same period ended March 31, 2005. The ratio of the allowance for loan losses to total loans at the end of the first

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three months of 2006 was 1.11%, which compares to 1.16% at the same period last year. The net charge-off ratio at March 31, 2006 was 0.04%, and it was 0.17% at March 31, 2005.

The Company regularly reviews asset quality and re-evaluates the allowance for loan losses. Reviews are conducted for each of the two bank subsidiaries, and an appropriate provision and allowance for loan losses is established for each bank, depending upon factors that are unique to that bank and the quality of its loan portfolio. Because of the continued excellent overall quality of the loan portfolio, 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".)

Noninterest Income

	March 31, 2006	March 31, 2005	March 31, 2004
Service charges on deposits	\$815	\$675	\$675

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Other service charges and fees	109	87	7
Credit card fees	524	494	38
Trust fees	380	408	50
Other income	267	137	10
Realized securities gains (losses)	(36)	(33)	(

Noninterest income is made up 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

The principal factors affecting current or future levels of income from this category are:

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

Service charges on deposits were \$815 at March 31, 2006, an increase of \$140 or 20.74%. Of that increase, approximately \$135 was due to increases in fees for overdrafts and returned checks. In early 2005 the Company increased its charge for each overdrawn item, and the amount of daily maximum charges was increased.

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 other service charges and fees vary. Fees for the issuance 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 by themselves yield a significant increase in income when they change. 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 volume.

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Other service charges and fees at March 31, 2006 were \$109, as compared with \$87 for the same period the prior year. Of the \$22 increase, approximately \$10 was due to increases in fees associated with cashing income tax refund checks. Another \$5 came from increased fees for letters of credit. The remainder of the increase were in the safe deposit box, and credit life insurance categories.

Credit card fees consist of three types of revenues.

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- 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.

Credit card fees increased by \$30 or 6.07% when March 31, 2006 and March 31, 2005 are compared. The increase was attributable to volume.

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 2006, the financial markets have experienced a degree of volatility. Income from estates is also unpredictable. Trust income for the first three months of 2006 was \$380, a decrease of \$28 from the previous year. The decline was the result of fluctuations in income derived from the settlement of estates.

Other income is used for types of income that cannot be classified with other categories 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, trends or patterns are not identifiable. Other income increased \$130 when March 31, 2006 and March 31, 2005 are compared. Of the \$130 change, approximately \$112 was attributable to increases in cash value associated with bank owned life insurance policies.

Realized net gains and losses on securities include write-downs in certain investments in limited liability companies (LLC's) of which the Company is part owner, as well as sales, maturities and calls of securities.

Realized gains and losses were (\$36) for the period ended March 31, 2006. The majority of this loss was attributable to write-downs in investments in limited liability companies (LLC's).

Noninterest Expense

	March 31, 2006	March 31, 2005	March
Salaries and employee benefits	\$2,911	\$2,862	\$2
Occupancy and furniture and fixtures	533	479	
Data processing and ATM	301	467	
Credit card processing	413	376	

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Intangibles and goodwill amortization	284	266
Net costs of other real estate owned	14	108
Other operating expenses	1,043	1,131

Noninterest expense includes several categories. A brief description of the factors that affect each follows.

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 Qualified Pension plans (1)
- o Supplemental retirement plan (salary continuation agreements)
- o Employer FICA
- o Unemployment taxes

(1) See the 2005 Form 10-K and the Proxy Statement for the 2006 Annual Meeting of Stockholders for further information.

Salaries and employee benefits expense was \$2,911 at March 31, 2006, an increase of \$49 or 1.71% when compared with the same period in 2005. Included in the increase is an \$83 expense associated with a supplemental retirement plan that provides for salary continuation agreements with selected officers of the Company and its affiliates. This expense was offset by income from bank owned life insurance on the plan participants. (See the discussion of "Other Income".) The Company employed 283 fulltime equivalent employees at March 31, 2006 and 274 at March 31, 2005.

Occupancy costs include such items as depreciation expense, maintenance of the properties, repairs and real estate taxes. At March 31, 2006, occupancy and furniture and fixture expense was \$533, an increase of \$54 or 11.27% over the end of the first quarter last year. In anticipation of the planned merger of its NBB and BTC affiliates, the Company accrued \$35 for the cost of new signage that will be required at the time of the merger, and this expense accounts for the majority of the increase in the occupancy, furniture and fixtures category.

Data processing and ATM expense decreased by \$166 when compared to March 31, 2005. A decline in maintenance cost of approximately \$93 and a decrease in conversion expenses of \$58 account for most of the decrease.

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 "Noninterest Income", and the comments in that section are applicable. Credit card processing expense was \$413 for the three months ended March 31, 2006, an increase of \$37 from the same period in 2005. Volume accounted for the increase.

Intangible expense is influenced by acquisitions, amortization schedules and impairment testing depending on the nature of the intangible. Core deposit intangibles are amortized while goodwill is subject to testing for impairment. Both generally increase with acquisitions. Intangibles amortization expense at March 31, 2006 was \$284, an increase of \$18 over the same period the previous year. The increase was associated with the acquisition of two branches acquired in February 2005.

Net cost of other real estate owned consists of losses on disposal, repairs, write-downs and other foreclosure costs. Net costs of other real estate owned was down \$94 when compared to the first quarter of last year. This category can fluctuate substantially depending on the number of properties on hand, the gains or losses on sale and the amount of write-downs.

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. Other operating expenses for the first quarter of 2006 were \$1,043, down \$88 from the same period in the prior year.

Balance Sheet

Year-to-date daily averages for the major balance sheet categories are as follows:

Assets	March 31, 2006	December 31, 2005

Federal funds sold	\$ ---	\$ ---
Interest-bearing deposits	14,089	14,819
Securities available for sale	163,429	151,431
Securities held to maturity	109,215	110,312
Mortgage loans held for sale	214	609
Real estate construction loans	27,378	26,926
Real estate mortgage loans	115,801	117,855
Commercial and industrial loans	264,958	260,197
Loans to individuals	83,273	88,690
Total Assets	\$ 839,478	\$ 819,341
Liabilities and stockholders equity		

Noninterest-bearing demand deposits	\$ 111,953	\$114,186
Interest-bearing demand deposits	224,404	204,522
Savings deposits	54,550	57,836
Time deposits	351,034	347,471
Other borrowings	163	705
Shareholders' equity	\$93,419	\$90,470

Loans

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 March 31, 2006 there was approximately \$3,898 in outstanding commitments to extend mortgage loans.

Construction loans were \$27,290 at March 31, 2006 and \$27,116 at December 31, 2005, an increase of \$174. This category tends to fluctuate because of demand and with the seasons. Demand also may vary because of economic conditions. 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 March 31, 2006 were \$117,326, which represents a

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decrease of \$95 from December 31, 2005. Loans in this category are for one-to-four family housing and are loans the banking affiliates elected to retain rather than to sell on the secondary market.

Commercial and industrial loans were \$264,300 at March 31, 2006, an increase of \$151 from December 31, 2005. Included in this category are loans for working capital, equipment, commercial real estate and other loans for business needs. See Note 15 of the Company's 2005 Form 10-K for information related to "Concentrations of Credit".

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Loans to individuals decreased by \$2,997 when March 31, 2006 is compared to December 31, 2005.

Total deposits at March 31, 2006 increased by \$3,573 from December 31, 2005. Noninterest-bearing demand deposits increased by \$5,450 when March 31, 2006 is compared to December 31, 2005. During the same period, interest-bearing demand deposits decreased by \$371, and time deposits decreased by \$2,211.

Liquidity and Capital Resources

Net cash provided by operating activities was \$3,611 for the period ended March 31, 2006, which compares to \$3,793 for the same period the previous year.

Net cash used in investing activities was \$8,541 for the period ended March 31, 2006, and \$20,365 used for the period ended March 31, 2005. Net cash provided by financing activities was \$3,085 for the period ending March 31, 2006.

Management is unaware of any commitment that would have a material and adverse effect on liquidity at March 31, 2006.

Total shareholders' equity grew by \$2,321 from December 31, 2005 to March 31, 2006. Earnings and the changes in unrealized gains and losses for securities available for sale accounted for the net increase. During the first three months of 2006, the Company repurchased 10,700 shares of its own stock for approximately \$255 at an average price of \$23.81 (excluding broker commission). The Tier I and Tier II risk-based capital ratios at March 31, 2006 were 13.61% and 14.55%, respectively. The Company's leverage capital ratio was 9.64%

Interest Rate Sensitivity

Following is a table showing repricing and maturity data for the Company's interest-earning assets and interest-bearing liabilities:

March 31, 2006

Assets