

NATIONAL BANKSHARES INC

Form 10-Q

May 08, 2013

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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, 2013

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 or other jurisdiction of incorporation or organization)

54-1375874  
(I.R.S. Employer Identification No.)

101 Hubbard Street  
P. O. Box 90002  
Blacksburg, VA  
(Address of principal executive offices)

24062-9002  
(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

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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 May 1, 2013 |
|--------------------------------|----------------------------|
| Common Stock, \$1.25 Par Value | 6,947,974                  |

(This report contains 52 pages)

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NATIONAL BANKSHARES, INC. AND SUBSIDIARIES  
Form 10-Q  
Index

| <u>Part I – Financial Information</u> |  | Page    |
|---------------------------------------|--|---------|
| Item 1                                | <u>Financial Statements</u>  | 3       |
|                                       | <u>Consolidated Balance Sheets, March 31, 2013 (Unaudited) and December 31, 2012</u>   | 3       |
|                                       | <u>Consolidated Statements of Income for the Three Months Ended March 31, 2013 and 2012 (Unaudited)</u>                          | 4 - 5   |
|                                       | <u>Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2013 and 2012 (Unaudited)</u>            | 6       |
|                                       | <u>Consolidated Statements of Changes in Stockholders' Equity for the Three Months Ended March 31, 2013 and 2012 (Unaudited)</u> | 7       |
|                                       | <u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2013 and 2012 (Unaudited)</u>                      | 8 - 9   |
|                                       | <u>Notes to Consolidated Financial Statements (Unaudited)</u>  | 10 – 35 |
| Item 2                                | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                     | 36 – 44 |
| Item 3                                | <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 45      |
| Item 4                                | <u>Controls and Procedures</u>   | 46      |
| <u>Part II – Other Information</u>    |  |         |
| Item 1                                | <u>Legal Proceedings</u>   | 46      |
| Item 1A                               | <u>Risk Factors</u>  | 46      |
| Item 2                                | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 46      |
| Item 3                                | <u>Defaults Upon Senior Securities</u>   | 46      |
| Item 4                                | <u>Mine Safety Disclosures</u>   | 47      |
| Item 5                                | <u>Other Information</u>   | 47      |
| Item 6                                | <u>Exhibits</u>  | 47      |

|                          |         |
|--------------------------|---------|
| <u>Signatures</u>        | 47      |
| <u>Index of Exhibits</u> | 48 – 49 |
| <u>Certifications</u>    | 50 - 52 |

## Part I

## Financial Information

## Item 1. Financial Statements

National Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

| \$ in thousands, except per share data  | (Unaudited)<br>March 31,<br>2013 | December 31,<br>2012 |
|---|----------------------------------|----------------------|
| <b>Assets</b>   |                                  |                      |
| Cash and due from banks   | \$ 10,674                        | \$ 14,783            |
| Interest-bearing deposits   | 107,176                          | 96,597               |
| Securities available for sale, at fair value  | 191,540                          | 189,815              |
| Securities held to maturity (fair value approximates \$174,218 at March 31, 2013 and \$170,846 at December 31, 2012)                            | 166,947                          | 160,539              |
| Restricted stock, at cost   | 1,414                            | 1,689                |
| Mortgage loans held for sale  | 313                              | 2,796                |
| <b>Loans:</b>   |                                  |                      |
| Loans, net of unearned income and deferred fees   | 574,958                          | 592,162              |
| Less allowance for loan losses  | (8,291)                          | (8,349)              |
| Loans, net  | 566,667                          | 583,813              |
| Premises and equipment, net   | 10,237                           | 10,401               |
| Accrued interest receivable   | 5,878                            | 6,247                |
| Other real estate owned, net  | 1,094                            | 1,435                |
| Intangible assets and goodwill  | 9,106                            | 9,377                |
| Bank-owned life insurance   | 20,690                           | 20,523               |
| Other assets  | 6,767                            | 6,346                |
| <b>Total assets</b>   | <b>\$ 1,098,503</b>              | <b>\$ 1,104,361</b>  |
| <b>Liabilities and Stockholders' Equity</b>   |                                  |                      |
| Noninterest-bearing demand deposits   | \$ 144,815                       | \$ 144,252           |
| Interest-bearing demand deposits  | 449,992                          | 455,713              |
| Savings deposits  | 72,420                           | 69,063               |
| Time deposits   | 269,892                          | 277,738              |
| <b>Total deposits</b>   | <b>937,119</b>                   | <b>946,766</b>       |
| Accrued interest payable  | 146                              | 139                  |
| Other liabilities   | 7,878                            | 7,347                |
| <b>Total liabilities</b>  | <b>945,143</b>                   | <b>954,252</b>       |
| Commitments and contingencies   | ---                              | ---                  |
| <b>Stockholders' Equity</b>   |                                  |                      |
| Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding   | ---                              | ---                  |
| Common stock of \$1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,947,974 shares at March 31, 2013 and December 31, 2012 | 8,685                            | 8,685                |
| Retained earnings   | 148,378                          | 144,162              |
| Accumulated other comprehensive loss, net   | (3,703)                          | (2,738)              |

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|  |              |              |
|--|--------------|--------------|
| Total stockholders' equity                 | 153,360      | 150,109      |
| Total liabilities and stockholders' equity | \$ 1,098,503 | \$ 1,104,361 |

See accompanying notes to consolidated financial statements.

3

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National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

| \$ in thousands, except per share data   | March 31,<br>2013 | March 31,<br>2012 |
|--|-------------------|-------------------|
| <b>Interest Income</b>   |                   |                   |
| Interest and fees on loans   | \$ 8,319          | \$ 8,878          |
| Interest on interest-bearing deposits  | 58                | 71                |
| Interest on securities – taxable   | 1,539             | 1,589             |
| Interest on securities – nontaxable  | 1,648             | 1,576             |
| Total interest income  | 11,564            | 12,114            |
| <b>Interest Expense</b>  |                   |                   |
| Interest on time deposits of \$100,000 or more   | 268               | 425               |
| Interest on other deposits   | 1,411             | 1,692             |
| Total interest expense   | 1,679             | 2,117             |
| Net interest income  | 9,885             | 9,997             |
| Provision for loan losses  | 671               | 672               |
| Net interest income after provision for loan losses  | 9,214             | 9,325             |
| <b>Noninterest Income</b>  |                   |                   |
| Service charges on deposit accounts  | 588               | 631               |
| Other service charges and fees   | 60                | 49                |
| Credit card fees   | 740               | 794               |
| Trust income   | 289               | 326               |
| BOLI income  | 188               | 200               |
| Other income   | 150               | 99                |
| Realized securities gains, net (includes accumulated other comprehensive income reclassification adjustments for unrealized net gains in available-for-sale securities of \$95 for the three months ended March 31, 2013 and \$44 for the three months ended March 31, 2012) | 95                | 53                |
| Total noninterest income   | 2,110             | 2,152             |
| <b>Noninterest Expense</b>   |                   |                   |
| Salaries and employee benefits   | 2,940             | 2,956             |
| Occupancy and furniture and fixtures   | 432               | 397               |
| Data processing and ATM  | 393               | 392               |
| FDIC assessment  | 136               | 109               |
| Credit card processing   | 552               | 572               |
| Intangible assets amortization   | 271               | 271               |
| Net costs of other real estate owned   | 75                | 48                |
| Franchise taxes  | 258               | 162               |



|   |           |           |
|---|-----------|-----------|
| Other operating expenses  | 889       | 804       |
| Total noninterest expense   | 5,946     | 5,711     |
| Income before income taxes  | 5,378     | 5,766     |
| Income tax expense (includes income tax expense from reclassification items of \$33 for the three months ended March 31, 2013 and \$15 for the three months ended March 31, 2012) | 1,162     | 1,337     |
| Net Income  | \$ 4,216  | \$ 4,429  |
| Basic net income per share  | \$ 0.61   | \$ 0.64   |
| Fully diluted net income per share  | \$ 0.60   | \$ 0.64   |
| Weighted average number of common shares outstanding – basic  | 6,947,974 | 6,939,974 |
| Weighted average number of common shares outstanding – diluted  | 6,969,073 | 6,954,637 |
| Dividends declared per share  | \$---     | \$---     |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
 Consolidated Statements of Comprehensive Income  
 Three Months Ended March 31, 2013 and 2012  
 (Unaudited)

| \$ in thousands  | March 31,<br>2013 | March 31,<br>2012 |
|--|-------------------|-------------------|
| Net Income   | \$ 4,216          | \$ 4,429          |
| <b>Other Comprehensive Loss, Net of Tax</b>  |                   |                   |
| Unrealized holding losses on available for sale securities net of taxes of (\$487) and (\$489) for the periods ended March 31, 2013 and 2012, respectively | (903)             | (907)             |
| Reclassification adjustment, net of taxes of (\$33) and (\$15) for the periods ended March 31, 2013 and 2012, respectively                                 | (62)              | (29)              |
| Other comprehensive loss, net of taxes of (\$520) and (\$504) for the periods ended March 31, 2013 and 2012, respectively                                  | (965)             | (936)             |
| Total Comprehensive Income   | \$ 3,251          | \$ 3,493          |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
 Consolidated Statements of Changes in Stockholders' Equity  
 Three Months Ended March 31, 2013 and 2012  
 (Unaudited)

| \$ in thousands                              | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total      |
|--|-----------------|----------------------|---|------------|
| Balances at December 31, 2011                | \$ 8,675        | \$ 133,945           | \$ (1,321 )                                   | \$ 141,299 |
| Net income                                   | ---             | 4,429                | ---   | 4,429      |
| Other comprehensive loss, net of tax (\$504) | ---             | ---                  | (936 )  | (936 )     |
| Balances at March 31, 2012                   | \$ 8,675        | \$ 138,374           | \$ (2,257 )                                   | \$ 144,792 |
| Balances at December 31, 2012                | \$ 8,685        | \$ 144,162           | \$ (2,738 )                                   | \$ 150,109 |
| Net income                                   | ---             | 4,216                | ---   | 4,216      |
| Other comprehensive loss, net of tax (\$520) | ---             | ---                  | (965 )  | (965 )     |
| Balances at March 31, 2013                   | \$ 8,685        | \$ 148,378           | \$ (3,703 )                                   | \$ 153,360 |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

| \$ in thousands  | March 31,<br>2013 | March 31,<br>2012 |
|--|-------------------|-------------------|
| <b>Cash Flows from Operating Activities</b>  |                   |                   |
| Net income   | \$ 4,216          | \$ 4,429          |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                   |                   |
| Provision for loan losses  | 671               | 672               |
| Depreciation of bank premises and equipment  | 188               | 192               |
| Amortization of intangibles  | 271               | 271               |
| Amortization of premiums and accretion of discounts, net                                       | 47                | 56                |
| Gains on sales and calls of securities available for sale, net                                 | (95 )             | (44 )             |
| Gains on calls of securities held to maturity, net   | ---               | (9 )              |
| (Gains) losses and write-downs on other real estate owned                                      | 11                | (24 )             |
| Increase in cash value of bank-owned life insurance  | (167 )            | (179 )            |
| Net change in:   |                   |                   |
| Mortgage loans held for sale   | 2,483             | 1,252             |
| Accrued interest receivable  | 369               | 129               |
| Other assets   | 99                | 124               |
| Accrued interest payable   | 7                 | (15 )             |
| Other liabilities  | 531               | 803               |
| Net cash provided by operating activities  | 8,631             | 7,657             |
| <b>Cash Flows from Investing Activities</b>  |                   |                   |
| Net change interest-bearing deposits   | (10,579 )         | (2,946 )          |
| Proceeds from calls, principal payments, sales and maturities of securities available for sale | 36,460            | 41,146            |
| Proceeds from calls, principal payments and maturities of securities held to maturity          | 4,042             | 13,846            |
| Purchases of securities available for sale   | (39,040 )         | (66,041 )         |
| Purchases of securities held to maturity   | (10,483 )         | (9,239 )          |
| Net change in restricted stock   | (274 )            | 22                |
| Purchases of loan participations   | (900 )            | ---               |
| Collections of loan participations   | 51                | 90                |
| Loan originations and principal collections, net   | 16,952            | 3,116             |
| Proceeds from disposal of other real estate owned  | 677               | 573               |
| Recoveries on loans charged off  | 25                | 23                |
| Additions to bank premises and equipment   | (24 )             | (362 )            |
| Net cash used in investing activities  | (3,093 )          | (19,772 )         |
| <b>Cash Flows from Financing Activities</b>  |                   |                   |
| Net change in time deposits  | (7,846 )          | (5,023 )          |
| Net change in other deposits   | (1,801 )          | 17,482            |
| Net cash provided by (used in) financing activities  | (9,647 )          | 12,459            |
| Net change in cash and due from banks  | (4,109 )          | 344               |

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|  |           |           |
|--|-----------|-----------|
| Cash and due from banks at beginning of period | 14,783    | 11,897    |
| Cash and due from banks at end of period       | \$ 10,674 | \$ 12,241 |

Supplemental Disclosures of Cash Flow Information

|  |         |         |
|--|---------|---------|
| Interest paid on deposits and borrowed funds | \$1,672 | \$2,132 |
| Income taxes paid                            | 59      | 196     |

Supplemental Disclosure of Noncash Activities

|  |          |          |
|--|----------|----------|
| Loans charged against the allowance for loan losses    | \$754    | \$700    |
| Loans transferred to other real estate owned           | 347      | ---      |
| Unrealized net losses on securities available for sale | (1,485 ) | (1,440 ) |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
March 31, 2013  
(Unaudited)

\$ in thousands, except per share data

Note 1: General

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (“NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, 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, 2013 are not necessarily indicative of 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 2012 Form 10-K/A. 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](http://www.nationalbankshares.com).

Subsequent events have been considered through the date when the Form 10-Q was issued.

Note 2: Stock-Based Compensation

The Company had a stock option plan, the 1999 Stock Option Plan, that was adopted in 1999 and that was terminated on March 9, 2009. Incentive stock options were granted annually to key employees of NBI and its subsidiaries from 1999 to 2005 and none have been granted since 2005. All of the stock options are vested.

| Options                        | Shares | Weighted<br>Average<br>Exercise<br>Price Per<br>Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|--------|---|---|---------------------------------|
| Outstanding at January 1, 2013 | 69,000 | \$ 23.75  |   |                                 |
| Exercised                      | ---    | ---   |   |                                 |
| Forfeited or expired           | ---    | ---   |   |                                 |
| Outstanding March 31, 2013     | 69,000 | \$ 23.75  | 3.58  | \$ 771                          |
| Exercisable at March 31, 2013  | 69,000 | \$ 23.75  | 3.58  | \$ 771                          |

There were no shares exercised during the three months ended March 31, 2013 and 2012. As of March 31, 2013, there was no unrecognized compensation expense related to stock options.

## Note 3: Loan Portfolio

The loan portfolio, excluding loans held for sale, was comprised of the following.

|   | March 31,<br>2013 | December<br>31,<br>2012 |
|---|-------------------|-------------------------|
| Real estate construction                        | \$50,848          | \$50,313                |
| Consumer real estate                            | 139,694           | 143,262                 |
| Commercial real estate                          | 294,578           | 304,308                 |
| Commercial non real estate                      | 35,478            | 37,349                  |
| Public sector and IDA                           | 26,686            | 26,169                  |
| Consumer non real estate                        | 28,581            | 31,714                  |
| Gross loans                                     | 575,865           | 593,115                 |
| Less unearned income and deferred fees          | (907 )            | (953 )                  |
| Loans, net of unearned income and deferred fees | \$574,958         | \$592,162               |

## Note 4: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

The allowance for loan losses methodology incorporates individual evaluation of impaired loans and collective evaluation of groups of non-impaired loans. The Company performs ongoing analysis of the loan portfolio to determine credit quality and to identify impaired loans. Credit quality is rated based on the loan's payment history, the borrower's current financial situation and value of the underlying collateral.

Impaired loans are those loans that have been modified in a troubled debt restructure ("TDR" or "restructure") and larger, non-homogeneous loans that are in nonaccrual or exhibit payment history or financial status that indicate the probability that collection will not occur according to the loan's terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as "classified" or "other assets especially mentioned." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair market value. Impaired loans with an impairment loss are designated nonaccrual. Please refer to Note 1 of the Company's 2012 Form 10-K/A, "Summary of Significant Accounting Policies" for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Further, restructured loans are individually evaluated for impairment, with amounts below fair value accrued in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were included in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent or for which decreased cash flows indicate a decline in fair value are charged down to fair value.

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. The methodology for calculating reserves for collectively-evaluated loans is applied at the class level.

## Portfolio Segments and Classes

During the first quarter of 2013, the Company segregated certain loans that were included within the classes of the Residential Real Estate segment, including Equity lines, Residential closed-end first liens and Residential closed-end junior liens. The newly-segregated loans are secured by residential real estate collateral that is owned by investors and



for which the primary repayment source is rental income. The new class in the Residential Real Estate segment allows the Company to address credit risks characteristic of investor-owned residential real estate. Segregating the investor-owned residential real estate did not have a significant impact on the calculation of the allowance for loan losses. Consistent with accounting guidance, prior periods have not been restated and are shown as originally published using the segments and classes in effect for the period.

The segments and classes used in determining the allowance for loan losses, beginning with the first quarter of 2013 are as follows.

|  |                            |
|--|----------------------------|
| Real Estate Construction               | Commercial Non Real Estate |
| Construction, residential              | Commercial and Industrial  |
| Construction, other                    |                            |
|  | Public Sector and IDA      |
| Consumer Real Estate                   | Public sector and IDA      |
| Equity lines                           |                            |
| Residential closed-end first liens     | Consumer Non Real Estate   |
| Residential closed-end junior liens    | Credit cards               |
| Investor-owned residential real estate | Automobile                 |
|  | Other consumer loans       |
| Commercial Real Estate                 |                            |
| Multifamily real estate                |                            |
| Commercial real estate, owner occupied |                            |
| Commercial real estate, other          |                            |

#### Historical Loss Rates

The Company's allowance methodology for collectively-evaluated loans applies historical loss rates by class to current class balances as part of the process of determining required reserves. Class loss rates are calculated as the net charge-offs for the class as a percentage of average class balance. The annualized current-year loss rate is averaged with that of prior periods to obtain the historical loss rate. Prior to the first quarter of 2013, one historical loss rate for each class was calculated and applied to current class balance to obtain the allocation for historical loss rates.

Beginning with the first quarter of 2013, two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance ("class loss rate"), and total net charge-offs for the class as a percentage of average classified loans in the class ("classified loss rate"). Classified loans are those with risk ratings of "substandard" or higher. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

The revised calculation and application of historical loss rates impacted the calculation of reserves for collectively-evaluated loans. Under the former methodology, the class historical loss rates were applied to all collectively-evaluated loans and would have resulted in a total allocation of \$2,712. Under the revised methodology, class historical loss rates are applied to only non-classified loans, resulting in an allocation of \$2,624. In addition, the classified historical loss rate resulted in an allocation of \$900, for a total allocation based on historical loss rates of \$3,524. Consistent with accounting guidance, prior periods have not been restated and are shown as originally published using the methodology in effect for the period.

#### Risk Factors

In addition to historical loss rates, risk factors pertinent to each class are analyzed to estimate reserves for collectively-evaluated loans. Factors include changes in national and local economic and business conditions, the nature and volume of classes within the portfolio, loan quality and loan officers' experience. Prior to the first quarter of 2013, management also reviewed the Company's lending policies and loan review system to determine whether changes had occurred during the quarter that affected credit risk. Until the first quarter of 2013, no changes were found to affect credit risk and no additional allocations were applied. During the first quarter of 2013, the Company incorporated to the allowance methodology a factor for changes in the Company's lending policies and a factor for changes in the quality of the Company's loan review, and set standard allocations for associated risk. The addition of

the factors formalized and standardized a practice already in place and did not have a significant impact on the calculation of the allowance for loan losses.

Factor allocations applied to each class are increased for loans rated special mention and increased to a greater extent for loans rated classified. The Company allocates additional reserves for “high risk” loans, determined to be junior lien mortgages, high loan-to-value loans and interest-only loans.

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A detailed analysis showing the allowance roll-forward by portfolio segment and related loan balance by segment follows.

Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2013

|                            | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and<br>IDA | Consumer<br>Non<br>Real<br>Estate | Unallocated | Total   |
|----------------------------|--------------------------------|----------------------------|------------------------------|----------------------------------|--------------------------------|-----------------------------------|-------------|---------|
| Balance, December 31, 2012 | \$1,070                        | \$ 2,263                   | \$ 3,442                     | \$ 959                           | \$142                          | \$ 424                            | \$ 49       | \$8,349 |
| Charge-offs                | (184 )                         | (53 )                      | (35 )                        | (404 )                           | ---                            | (78 )                             | ---         | (754 )  |
| Recoveries                 | ---                            | ---                        | ---                          | 16                               | ---                            | 9                                 | ---         | 25      |
| Provision for loan losses  | 287                            | (364 )                     | (118 )                       | 705                              | (32 )                          | 230                               | (37 )       | 671     |
| Balance, March 31, 2013    | \$1,173                        | \$ 1,846                   | \$ 3,289                     | \$ 1,276                         | \$110                          | \$ 585                            | \$ 12       | \$8,291 |

Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2012

|                            | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and<br>IDA | Consumer<br>Non<br>Real<br>Estate | Unallocated | Total   |
|----------------------------|--------------------------------|----------------------------|------------------------------|----------------------------------|--------------------------------|-----------------------------------|-------------|---------|
| Balance, December 31, 2011 | \$1,079                        | \$ 1,245                   | \$ 3,515                     | \$ 1,473                         | \$232                          | \$ 403                            | \$ 121      | \$8,068 |
| Charge-offs                | ---                            | (95 )                      | (537 )                       | ---                              | ---                            | (68 )                             | ---         | (700 )  |
| Recoveries                 | ---                            | ---                        | ---                          | ---                              | ---                            | 23                                | ---         | 23      |
| Provision for loan losses  | (405 )                         | 1,102                      | 242                          | (347 )                           | (147 )                         | 124                               | 103         | 672     |
| Balance, March 31, 2012    | \$674                          | \$ 2,252                   | \$ 3,220                     | \$ 1,126                         | \$85                           | \$ 482                            | \$ 224      | \$8,063 |

Allowance for Loan Losses as of March 31, 2013

|                                       | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and<br>IDA | Consumer<br>Non Real<br>Estate | Unallocated | Total   |
|---------------------------------------|--------------------------------|----------------------------|---------------------------|----------------------------------|--------------------------------|--------------------------------|-------------|---------|
| Individually evaluated for impairment | \$---                          | \$---                      | \$ 269                    | \$ 1                             | \$---                          | \$ 3                           | \$ ---      | \$273   |
| Collectively evaluated for impairment | 1,173                          | 1,846                      | 3,020                     | 1,275                            | 110                            | 582                            | 12          | 8,018   |
| Total                                 | \$1,173                        | \$1,846                    | \$ 3,289                  | \$ 1,276                         | \$110                          | \$585                          | \$ 12       | \$8,291 |

Allowance for Loan Losses as of December 31, 2012

Unallocated Total

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|   | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and IDA | Consumer<br>Non Real<br>Estate |        |          |
|---|--------------------------------|----------------------------|------------------------------|----------------------------------|-----------------------------|--------------------------------|--------|----------|
| Individually<br>evaluated for<br>impairment | \$ ---                         | \$ 43                      | \$ 273                       | \$ 231                           | \$ ---                      | \$ 7                           | \$ --- | \$ 554   |
| Collectively<br>evaluated for<br>impairment | 1,070                          | 2,220                      | 3,169                        | 728                              | 142                         | 417                            | 49     | 7,795    |
| Total                                       | \$ 1,070                       | \$ 2,263                   | \$ 3,442                     | \$ 959                           | \$ 142                      | \$ 424                         | \$ 49  | \$ 8,349 |

|                                       | Loans as of March 31, 2013 |                      |                        |                            |                       |                          |       | Unallocated | Total |
|---------------------------------------|----------------------------|----------------------|------------------------|----------------------------|-----------------------|--------------------------|-------|-------------|-------|
|                                       | Real Estate                | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate |       |             |       |
|                                       | Construction               | Estate               | Real Estate            | Estate                     |                       | Estate                   |       |             |       |
| Individually evaluated for impairment | \$6,492                    | \$478                | \$9,927                | \$318                      | \$---                 | \$43                     | \$--- | \$17,258    |       |
| Collectively evaluated for impairment | 44,356                     | 139,216              | 284,651                | 35,160                     | 26,686                | 28,538                   | ---   | 558,607     |       |
| Total loans                           | \$50,848                   | \$139,694            | \$294,578              | \$35,478                   | \$26,686              | \$28,581                 | \$--- | \$575,865   |       |

|                                       | Loans as of December 31, 2012 |                      |                        |                            |                       |                          |       | Unallocated | Total |
|---------------------------------------|-------------------------------|----------------------|------------------------|----------------------------|-----------------------|--------------------------|-------|-------------|-------|
|                                       | Real Estate                   | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate |       |             |       |
|                                       | Construction                  | Estate               | Real Estate            | Estate                     |                       | Estate                   |       |             |       |
| Individually evaluated for impairment | \$6,643                       | \$864                | \$10,329               | \$574                      | \$---                 | \$46                     | \$--- | \$18,456    |       |
| Collectively evaluated for impairment | 43,670                        | 142,398              | 293,979                | 36,775                     | 26,169                | 31,668                   | ---   | 574,659     |       |
| Total                                 | \$50,313                      | \$143,262            | \$304,308              | \$37,349                   | \$26,169              | \$31,714                 | \$--- | \$593,115   |       |

A summary of ratios for the allowance for loan losses follows.

|   | Three Months Ended |                | Year Ended        |
|---|--------------------|----------------|-------------------|
|   | 2013               | March 31, 2012 | December 31, 2012 |
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees | 1.44%              | 1.38%          | 1.41%             |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees(1)                  | 0.50%              | 0.46%          | 0.49%             |

(1) Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

|                                  | 2013      | March 31, 2012 | December 31, 2012 |
|----------------------------------|-----------|----------------|-------------------|
| Nonperforming assets:            |           |                |                   |
| Nonaccrual loans                 | \$ 10,734 | \$ 1,789       | \$ 10,870         |
| Restructured loans in nonaccrual | 1,691     | 3,539          | 2,151             |
| Total nonperforming loans        | 12,425    | 5,328          | 13,021            |

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|  |           |   |          |   |           |   |
|--|-----------|---|----------|---|-----------|---|
| Other real estate owned, net   | 1,094     |   | 940      |   | 1,435     |   |
| Total nonperforming assets   | \$ 13,519 |   | \$ 6,268 |   | \$ 14,456 |   |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 2.35      | % | 1.07     | % | 2.44      | % |
| Ratio of allowance for loan losses to nonperforming loans(1)   | 66.73     | % | 151.33   | % | 64.12     | % |

(1) The Company defines nonperforming loans as nonaccrual loans. Loans 90 days or more past due and still accruing and accruing restructured loans are excluded.

A summary of loans past due 90 days or more and impaired loans follows.

|  | 2013     | March 31,<br>2012 | December<br>31,<br>2012 |   |  |
|--|----------|-------------------|-------------------------|---|--|
| Loans past due 90 days or more and still accruing  | \$568    | \$210             | \$170                   |   |  |
| Ratio of loans past due 90 days or more and still accruing to loans,<br>net of unearned income and deferred fees | 0.10     | % 0.04            | % 0.03                  | % |  |
| Accruing restructured loans  | \$5,732  | \$3,742           | \$2,005                 |   |  |
| Impaired loans:  |          |                   |                         |   |  |
| Impaired loans with no valuation allowance   | \$16,263 | \$9,933           | \$16,974                |   |  |
| Impaired loans with a valuation allowance  | 995      | 3,054             | 1,482                   |   |  |
| Total impaired loans   | \$17,258 | \$12,987          | \$18,456                |   |  |
| Valuation allowance  | (273 )   | (593 )            | (554 )                  |   |  |
| Impaired loans, net of allowance   | \$16,985 | \$12,394          | \$17,902                |   |  |
| Average recorded investment in impaired loans(1)   | \$17,935 | \$14,555          | \$13,540                |   |  |
| Interest income recognized on impaired loans, after designation as<br>impaired                                   | \$10     | \$24              | \$9                     |   |  |
| Amount of income recognized on a cash basis  | \$---    | \$---             | \$---                   |   |  |

(1) Recorded investment includes principal, accrued interest and net deferred fees.



Nonaccrual loans that meet the Company's balance threshold of \$250 or are TDRs are designated as impaired. No interest income was recognized on nonaccrual loans for the three months ended March 31, 2013 or March 31, 2012 or for the year ended December 31, 2012.

A detailed analysis of investment in impaired loans, associated reserves and interest income recognized, segregated by loan class follows.

|  | Impaired Loans as of March 31, 2013 |                                  |   |  |                   |
|--|-------------------------------------|----------------------------------|---|--|-------------------|
|  | Principal Balance                   | (A) Total Recorded Investment(1) | Recorded Investment(1) in (A) for Which There is No Related Allowance | Recorded Investment(1) in (A) for Which There is a Related Allowance | Related Allowance |
| Real Estate Construction               |                                     |                                  |   |  |                   |
| Construction, residential              | \$ 123                              | \$ 118                           | \$ 118  | \$---  | \$---             |
| Construction, other                    | 6,369                               | 6,334                            | 6,334   | ---  | ---               |
| Consumer Real Estate                   |                                     |                                  |   |  |                   |
| Equity lines                           | ---                                 | ---                              | ---   | ---  | ---               |
| Residential closed-end first liens     | 315                                 | 315                              | 315   | ---  | ---               |
| Residential closed-end junior liens    | 80                                  | 80                               | 80  | ---  | ---               |
| Investor-owned residential real estate | 83                                  | 84                               | 84  | ---  | ---               |
| Commercial Real Estate                 |                                     |                                  |   |  |                   |
| Multifamily real estate                | 4,421                               | 4,417                            | 4,417   | ---  | ---               |
| Commercial real estate, owner occupied | 5,506                               | 5,513                            | 4,587   | 926  | 269               |
| Commercial real estate, other          | ---                                 | ---                              | ---   | ---  | ---               |
| Commercial Non Real Estate             |                                     |                                  |   |  |                   |
| Commercial and Industrial              | 318                                 | 318                              | 291   | 27   | 1                 |
| Public Sector and IDA                  |                                     |                                  |   |  |                   |
| Public sector and IDA                  | ---                                 | ---                              | ---   | ---  | ---               |
| Consumer Non Real Estate               |                                     |                                  |   |  |                   |
| Credit cards                           | ---                                 | ---                              | ---   | ---  | ---               |
| Automobile                             | 43                                  | 43                               | ---   | 43   | 3                 |
| Other consumer loans                   | ---                                 | ---                              | ---   | ---  | ---               |
| Total                                  | \$ 17,258                           | \$ 17,222                        | \$ 16,226   | \$ 996   | \$ 273            |

(1) Recorded investment includes the unpaid principal balance and any accrued interest and net deferred fees.

|  | Impaired Loans as of December 31, 2012 |   |   |  |                      |
|--|--|---|---|--|----------------------|
|  | Principal<br>Balance                   | (A)<br>Total<br>Recorded<br>Investment(1) | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is<br>No Related<br>Allowance | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is a<br>Related<br>Allowance | Related<br>Allowance |
| <b>Real Estate Construction</b>        |  |   |   |  |                      |
| Construction, residential              | \$123                                  | \$ 118                                    | \$118   | \$---  | \$---                |
| Construction, other                    | 6,520                                  | 6,487                                     | 6,487   | ---  | ---                  |
| <b>Consumer Real Estate</b>            |  |   |   |  |                      |
| Equity lines                           | ---                                    | ---                                       | ---   | ---  | ---                  |
| Residential closed-end first liens     | 783                                    | 785                                       | 634   | 151  | 43                   |
| Residential closed-end junior liens    | 81                                     | 81  | 81  | ---  | ---                  |
| <b>Commercial Real Estate</b>          |  |   |   |  |                      |
| Multifamily real estate                | 5,284                                  | 5,288                                     | 5,288   | ---  | ---                  |
| Commercial real estate, owner occupied | 5,045                                  | 5,043                                     | 4,293   | 750  | 273                  |
| Commercial real estate, other          | ---                                    | ---                                       | ---   | ---  | ---                  |
| <b>Commercial Non Real Estate</b>      |  |   |   |  |                      |
| Commercial and Industrial              | 574                                    | 574                                       | 39  | 535  | 231                  |
| <b>Public Sector and IDA</b>           |  |   |   |  |                      |
| Public sector and IDA                  | ---                                    | ---                                       | ---   | ---  | ---                  |
| <b>Consumer Non Real Estate</b>        |  |   |   |  |                      |
| Credit cards                           | ---                                    | ---                                       | ---   | ---  | ---                  |
| Automobile                             | 46                                     | 46  | ---   | 46   | 7                    |
| Other consumer loans                   | ---                                    | ---                                       | ---   | ---  | ---                  |
| <b>Total</b>                           | <b>\$18,456</b>                        | <b>\$ 18,422</b>                          | <b>\$16,940</b>   | <b>\$1,482</b>   | <b>\$554</b>         |

(1) Recorded investment includes the unpaid principal balance, accrued interest and any accrued interest and deferred fees.

The following tables show the average investment and interest income recognized for impaired loans.

|  | For the Three Months<br>Ended March 31, 2013 |                                  |
|--|--|----------------------------------|
|  | Average<br>Recorded<br>Investment(1)         | Interest<br>Income<br>Recognized |
| Real Estate Construction               |  |                                  |
| Construction, residential              | \$ 118                                       | \$ ---                           |
| Construction, other                    | 6,486  | ---                              |
| Consumer Real Estate                   |  |                                  |
| Equity lines                           | ---  | ---                              |
| Residential closed-end first liens     | 392  | ---                              |
| Residential closed-end junior liens    | 142  | ---                              |
| Investor-owned residential real estate | 84   | ---                              |
| Commercial Real Estate                 |  |                                  |
| Multifamily real estate                | 4,540  | ---                              |
| Commercial real estate, owner occupied | 5,599  | 10                               |
| Commercial real estate, other          | ---  | ---                              |
| Commercial Non Real Estate             |  |                                  |
| Commercial and Industrial              | 574  | ---                              |
| Public Sector and IDA                  |  |                                  |
| Public sector and IDA                  | ---  | ---                              |
| Consumer Non Real Estate               |  |                                  |
| Credit cards                           | ---  | ---                              |
| Automobile                             | ---  | ---                              |
| Other consumer                         | ---  | ---                              |
| Total                                  | \$ 17,935                                    | \$ 10                            |

(1) Recorded investment includes the unpaid principal balance and any accrued interest and net deferred fees.

|  | Average Investment and<br>Interest Income for<br>Impaired Loans<br>For the Year Ended<br>December 31, 2012 |                                  |
|--|--|----------------------------------|
|  | Average<br>Recorded<br>Investment(1)   | Interest<br>Income<br>Recognized |
| Real Estate Construction               |  |                                  |
| Construction, residential              | \$1,171  | \$ ---                           |
| Construction, other                    | 4,290  | 1                                |
| Commercial Real Estate                 |  |                                  |
| Equity lines                           | 101  | ---                              |
| Residential closed-end first liens     | 873  | 2                                |
| Residential closed-end junior liens    | 234  | ---                              |
| Commercial Real Estate                 |  |                                  |
| Multifamily real estate                | 1,466  | 5                                |
| Commercial real estate, owner occupied | 4,806  | 1                                |
| Commercial real estate, other          | ---  | ---                              |
| Commercial Non Real Estate             |  |                                  |
| Commercial and Industrial              | 570  | ---                              |
| Public Sector and IDA                  |  |                                  |
| Public sector and IDA                  | ---  | ---                              |
| Consumer Non Real Estate               |  |                                  |
| Credit cards                           | ---  | ---                              |
| Automobile                             | 4  | ---                              |
| Other consumer                         | 25   | ---                              |
| Total                                  | \$13,540   | \$ 9                             |

(1) Recorded investment includes the unpaid principal balance and any accrued interest and deferred fees.

An analysis of past due and nonaccrual loans as of March 31, 2013 follows.

|  | 30 – 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due and<br>Still<br>Accruing | Nonaccruals<br>(Including<br>Impaired<br>Nonaccruals) |
|--|-----------------------------|--------------------------------|---|---|
| Real Estate Construction               |                             |                                |   |   |
| Construction, residential              | \$---                       | \$123                          | \$---   | \$ 123  |
| Construction, other                    | 30                          | ---                            | ---   | 2,869   |
| Consumer Real Estate                   |                             |                                |   |   |
| Equity lines                           | 22                          | 49                             | 49  | ---   |
| Residential closed-end first liens     | 1,236                       | 731                            | 414   | 626   |
| Residential closed-end junior liens    | 336                         | 170                            | 51  | 119   |
| Investor-owned residential real estate | 196                         | ---                            | ---   | 3   |
| Commercial Real Estate                 |                             |                                |   |   |
| Multifamily real estate                | 943                         | 254                            | ---   | 4,421   |
| Commercial real estate, owner occupied | 670                         | 2,806                          | ---   | 3,810   |
| Commercial real estate, other          | 256                         | ---                            | ---   | ---   |
| Commercial Non Real Estate             |                             |                                |   |   |
| Commercial and Industrial              | 265                         | 258                            | ---   | 411   |
| Public Sector and IDA                  |                             |                                |   |   |
| Public sector and IDA                  | ---                         | ---                            | ---   | ---   |
| Consumer Non Real Estate               |                             |                                |   |   |
| Credit cards                           | 24                          | 6                              | 6   | ---   |
| Automobile                             | 185                         | 42                             | 42  | 43  |
| Other consumer loans                   | 132                         | 6                              | 6   | ---   |
| Total                                  | \$4,295                     | \$4,445                        | \$568   | \$ 12,425   |

An analysis of past due and nonaccrual loans follows:

December 31, 2012

|  | 30 – 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due and<br>Still<br>Accruing | Nonaccruals<br>(Including<br>Impaired<br>Nonaccruals) |
|--|-----------------------------|--------------------------------|---|---|
| <b>Real Estate Construction</b>        |                             |                                |   |   |
| Construction, residential              | \$---                       | \$123                          | \$---   | \$ 123  |
| Construction, other                    | 31                          | 89                             | ---   | 3,109   |
| <b>Consumer Real Estate</b>            |                             |                                |   |   |
| Equity lines                           | 22                          | 30                             | 30  | 98  |
| Residential closed-end first liens     | 1,507                       | 605                            | 126   | 801   |
| Residential closed-end junior liens    | 121                         | 39                             | ---   | 120   |
| <b>Commercial Real Estate</b>          |                             |                                |   |   |
| Multifamily real estate                | 671                         | 261                            | ---   | 4,624   |
| Commercial real estate, owner occupied | 1,113                       | ---                            | ---   | 3,536   |
| Commercial real estate, other          | 40                          | 2,089                          | ---   | ---   |
| <b>Commercial Non Real Estate</b>      |                             |                                |   |   |
| Commercial and Industrial              | 291                         | 505                            | ---   | 561   |
| <b>Public Sector and IDA</b>           |                             |                                |   |   |
| Public sector and IDA                  | ---                         | ---                            | ---   | ---   |
| <b>Consumer Non Real Estate</b>        |                             |                                |   |   |
| Credit cards                           | 20                          | 4                              | 4   | ---   |
| Automobile                             | 142                         | 10                             | 10  | 49  |
| Other consumer loans                   | 132                         | ---                            | ---   | ---   |
| <b>Total</b>                           | <b>\$4,090</b>              | <b>\$3,755</b>                 | <b>\$170</b>  | <b>\$ 13,021</b>                                      |

The estimate of credit risk for non-impaired loans is obtained by applying allocations for internal and external factors. The allocations are increased for loans that exhibit greater credit quality risk.

Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do not indicate heightened risk are graded as "pass." Loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than 75 days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans with frequent or persistent delinquency exceeding 75 days or that have a higher level of weakness in the borrower's financial condition are graded "classified." Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by 50% and by 100% for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of March 31, 2013 and 2012 and December 31, 2012.

The following displays collectively-evaluated loans by credit quality indicator.

March 31, 2013

|  | Pass       | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|--|------------|--------------------|---------------------------------------|
| Real Estate Construction               |            |                    |                                       |
| Construction, 1-4 family residential   | \$ 15,993  | \$ 158             | \$ ---                                |
| Construction, other                    | 28,154     | 6,086              | 30                                    |
| Consumer Real Estate                   |            |                    |                                       |
| Equity lines                           | 17,462     | ---                | 84                                    |
| Closed-end first liens                 | 75,434     | 283                | 2,739                                 |
| Closed-end junior liens                | 5,410      | 116                | 143                                   |
| Investor-owned residential real estate | 37,027     | 48                 | 48                                    |
| Commercial Real Estate                 |            |                    |                                       |
| Multifamily residential real estate    | 35,328     | ---                | 1,178                                 |
| Commercial real estate owner-occupied  | 144,248    | 215                | 1,239                                 |
| Commercial real estate other           | 93,264     | 3,092              | ---                                   |
| Commercial Non Real Estate             |            |                    |                                       |
| Commercial and Industrial              | 34,725     | 151                | 298                                   |
| Public Sector and IDA                  |            |                    |                                       |
| States and political subdivisions      | 26,686     | ---                | ---                                   |
| Consumer Non Real Estate               |            |                    |                                       |
| Credit cards                           | 6,292      | ---                | ---                                   |
| Automobile                             | 12,171     | 122                | 115                                   |
| Other consumer                         | 9,269      | 24                 | 68                                    |
| Total                                  | \$ 541,463 | \$ 10,295          | \$ 5,942                              |

The following displays collectively-evaluated loans by credit quality indicator.

December 31, 2012

|                                       | Pass             | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|---------------------------------------|------------------|--------------------|---------------------------------------|
| <b>Real Estate Construction</b>       |                  |                    |                                       |
| Construction, 1-4 family residential  | \$ 14,344        | \$ 158             | \$ ---                                |
| Construction, other                   | 29,011           | ---                | 120                                   |
| <b>Consumer Real Estate</b>           |                  |                    |                                       |
| Equity lines                          | 17,742           | 100                | 182                                   |
| Closed-end first liens                | 113,893          | 652                | 2,413                                 |
| Closed-end junior liens               | 6,713            | 119                | 138                                   |
| <b>Commercial Real Estate</b>         |                  |                    |                                       |
| Multifamily residential real estate   | 36,421           | ---                | 324                                   |
| Commercial real estate owner-occupied | 160,188          | 253                | 1,079                                 |
| Commercial real estate other          | 92,628           | 3,112              | ---                                   |
| <b>Commercial Non Real Estate</b>     |                  |                    |                                       |
| Commercial and Industrial             | 36,372           | 99                 | 318                                   |
| <b>Public Sector and IDA</b>          |                  |                    |                                       |
| States and political subdivisions     | 26,170           | ---                | ---                                   |
| <b>Consumer Non Real Estate</b>       |                  |                    |                                       |
| Credit cards                          | 6,690            | ---                | ---                                   |
| Automobile                            | 12,344           | 101                | 56                                    |
| Other consumer                        | 11,815           | 45                 | 105                                   |
| <b>Total</b>                          | <b>\$564,331</b> | <b>\$4,639</b>     | <b>\$4,735</b>                        |

#### Sales, Purchases and Reclassification of Loans

The Company finances mortgages under “best efforts” contracts with mortgage purchasers. The mortgages are designated as held for sale upon initiation. There have been no major reclassifications from portfolio loans to held for sale. Occasionally, the Company purchases or sells participations in loans. All participation loans purchased met the Company’s normal underwriting standards at the time the participation was entered. Participation loans are included in the appropriate portfolio balances to which the allowance methodology is applied.



### Troubled Debt Restructurings

The Company modified loans in troubled debt restructurings during the periods ended March 31, 2013 and March 31, 2012. The following tables present restructurings by class that occurred during the periods.

Note: Only classes with restructured loans are presented.

|  | Restructurings That Occurred During the<br>Three Months Ended<br>March 31, 2013 |   |  |
|--|---|---|--|
|  | Number<br>of<br>Contracts   | Pre-Modification<br>Outstanding<br>Principal<br>Balance | Post-Modification<br>Outstanding<br>Principal<br>Balance |
| Real Estate Construction               |   |   |  |
| Construction, other                    | 1   | \$ 3,500  | \$ 3,500   |
| Commercial Real Estate                 |   |   |  |
| Commercial real estate, owner occupied | 1   | 154   | 239  |
| Total                                  | 2   | \$ 3,654  | \$ 3,739   |

### Restructurings that occurred during the Three Months Ended March 31, 2012

|   | Number<br>of<br>Contracts | Pre-Modification                    | Post-Modification                |                       |
|---|---------------------------|-------------------------------------|----------------------------------|-----------------------|
|   |                           | Outstanding<br>Principal<br>Balance | Outstanding<br>Principal Balance | Impairment<br>Accrued |
| Consumer Real Estate                      |                           |                                     |                                  |                       |
| Closed-end first liens                    | 3                         | \$ 305                              | \$ 324                           | \$47                  |
| Closed-end junior liens                   | 1                         | 143                                 | 147                              | 109                   |
| Commercial Real Estate                    |                           |                                     |                                  |                       |
| Commercial real estate,<br>owner occupied | 1                         | 17                                  | 22                               | ---                   |
| Total                                     | 5                         | \$ 465                              | \$ 493                           | \$156                 |

Troubled debt restructurings totaled \$7,423, with specific allocations of \$1 as of March 31, 2013. At March 31, 2012, total restructured loans amounted to \$7,281 with specific allocations of \$289.

The troubled debt restructurings during the first three months of 2013 provided payment relief to the borrowers without forgiveness of principal or accrued interest. The interest-only period on one loan was extended beyond the contract date specified to begin amortization. On the other loan, the modification included an extended term, lower interest rate and new funds for debt consolidation to allow the borrower increased debt service ability. As troubled debt restructurings, the loans were individually evaluated under ASC 310. The impairment analysis was based upon the fair value of collateral for the construction loan and upon the present value of cash flows for the commercial real estate loan. The fair value measurements indicated fair values in excess of the loan balances and neither measurement resulted in a specific allocation.

The modifications during the first three months of 2012 provided payment relief primarily by extending maturity dates without reducing interest rates or amounts owed. Of the consumer real estate loans modified during the first quarter of 2012, two were loans previously modified and reported as troubled debt restructurings in prior quarters. The Company granted additional modifications in the first quarter of 2012, increasing the balance by \$10 from December 31, 2011. The loans are secured by real estate and the impairment measurement is based upon the fair value (reduced by selling costs) of the underlying collateral. The impairment measurement of the TDRs modified during the first three months of 2012 resulted in \$156 accrued to the allowance for loan losses.

The following tables present restructured loans that defaulted during the three-month periods ended March 31, 2013 and March 31, 2012 and that were modified within 12 months prior to default. The company defines default as one or more payments that occur more than 90 days past the due date, or charge-offs after the date of restructuring.

Restructured Loans That Defaulted  
During the Three Months Ended March  
31, 2013  
That Were Modified Within 12 Months  
Prior to Default

Number of  
Contracts                      Principal Balance

|                                       | Number of<br>Contracts | Principal Balance |
|---------------------------------------|------------------------|-------------------|
| Consumer Real Estate                  |                        |                   |
| Residential closed-end first liens    | 1                      | \$ 101            |
| Residential closed-end junior liens   | 1                      | 88                |
| Commercial Real Estate                |                        |                   |
| Commercial real estate owner-occupied | 1                      | 663               |
| Commercial Non Real Estate            |                        |                   |
| Commercial and industrial             | 1                      | 219               |
| Total                                 | 4                      | \$ 1,071          |

Restructured Loans That Defaulted  
During the Three Months Ended March  
31, 2012  
That Were Modified Within 12 Months  
Prior to Default

Number of  
Contracts                      Principal Balance

|                            | Number of<br>Contracts | Principal Balance |
|----------------------------|------------------------|-------------------|
| Consumer Real Estate       |                        |                   |
| Closed-end first liens     | 1                      | \$ 17             |
| Commercial Real Estate     |                        |                   |
| Multifamily                | 1                      | 250               |
| Commercial Non Real Estate |                        |                   |
| Commercial and industrial  | 1                      | 58                |
| Consumer Non Real Estate   |                        |                   |
| Other consumer             | 1                      | 67                |
| Total                      | 4                      | \$ 392            |

Restructured loans are individually evaluated for impairment. The fair value measurements for all of the restructured loans that experienced default during the three months ended March 31, 2013 and March 31, 2012 were based on the fair value of collateral and as such, were not significantly affected by the payment default. All of the above loans are in nonaccrual status.

## Note 5: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type are as follows.

|                                   | March 31, 2013 |            |            |           |
|-----------------------------------|----------------|------------|------------|-----------|
|                                   | Amortized      | Gross      | Gross      | Fair      |
|                                   | Costs          | Unrealized | Unrealized | Values    |
|                                   |                | Gains      | Losses     |           |
| Available for Sale:               |                |            |            |           |
| U.S. Treasury                     | \$2,003        | \$50       | \$---      | \$2,053   |
| U.S. Government agencies          | 137,851        | 976        | 1,189      | 137,638   |
| Mortgage-backed securities        | 3,739          | 333        | ---        | 4,072     |
| States and political subdivisions | 32,082         | 1,505      | 4          | 33,583    |
| Corporate                         | 11,809         | 178        | 52         | 11,935    |
| Other securities                  | 2,393          | ---        | 134        | 2,259     |
| Total                             | \$189,877      | \$3,042    | \$1,379    | \$191,540 |

|                                   | December 31, 2012 |            |            |           |
|-----------------------------------|-------------------|------------|------------|-----------|
|                                   | Amortized         | Gross      | Gross      | Fair      |
|                                   | Costs             | Unrealized | Unrealized | Values    |
|                                   |                   | Gains      | Losses     |           |
| Available for Sale:               |                   |            |            |           |
| U.S. Treasury                     | \$2,005           | \$68       | \$---      | \$2,073   |
| U.S. Government agencies          | 128,805           | 1,381      | 622        | 129,564   |
| Mortgage-backed securities        | 4,202             | 367        | ---        | 4,569     |
| States and political subdivisions | 35,029            | 1,753      | 3          | 36,779    |
| Corporate                         | 14,207            | 368        | ---        | 14,575    |
| Other securities                  | 2,419             | 9          | 173        | 2,255     |
| Total                             | \$186,667         | \$3,946    | \$798      | \$189,815 |

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type are as follows.

|                                   | March 31, 2013 |            |            |           |
|-----------------------------------|----------------|------------|------------|-----------|
|                                   | Amortized      | Gross      | Gross      | Fair      |
|                                   | Costs          | Unrealized | Unrealized | Values    |
|                                   |                | Gains      | Losses     |           |
| Held to Maturity:                 |                |            |            |           |
| U.S. Government agencies          | \$13,985       | \$507      | \$33       | \$14,459  |
| Mortgage-backed securities        | 644            | 72         | ---        | 716       |
| States and political subdivisions | 151,668        | 7,851      | 1,127      | 158,392   |
| Corporate                         | 650            | 1          | ---        | 651       |
| Total                             | \$166,947      | \$8,431    | \$1,160    | \$174,218 |

|                                   | December 31, 2012 |            |            |           |
|-----------------------------------|-------------------|------------|------------|-----------|
|                                   | Amortized         | Gross      | Gross      | Fair      |
|                                   | Costs             | Unrealized | Unrealized | Values    |
|                                   |                   | Gains      | Losses     |           |
| Held to Maturity:                 |                   |            |            |           |
| U.S. Government agencies          | \$7,988           | \$563      | \$---      | \$8,551   |
| Mortgage-backed securities        | 691               | 73         | ---        | 764       |
| States and political subdivisions | 151,209           | 9,880      | 216        | 160,873   |
| Corporate                         | 651               | 7          | ---        | 658       |
| Total                             | \$160,539         | \$10,523   | \$216      | \$170,846 |

Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows.

|   | March 31, 2013 |            |                   |            |
|---|----------------|------------|-------------------|------------|
|   | Less Than      | 12 Months  | 12 Months or More |            |
|   | Fair           | Unrealized | Fair              | Unrealized |
|   | Value          | Loss       | Value             | Loss       |
| Temporarily Impaired Securities:          |                |            |                   |            |
| U.S. Government agencies and corporations | \$85,100       | \$1,222    | \$---             | \$---      |
| States and political subdivisions         | 28,178         | 1,127      | 481               | 4          |
| Corporate debt securities                 | 3,974          | 52         | ---               | ---        |
| Other                                     | ---            | ---        | 360               | 134        |
| Total                                     | \$117,252      | \$2,401    | \$841             | \$138      |

|   | December 31, 2012 |            |                   |            |
|---|-------------------|------------|-------------------|------------|
|   | Less Than         | 12 Months  | 12 Months or More |            |
|   | Fair              | Unrealized | Fair              | Unrealized |
|   | Value             | Loss       | Value             | Loss       |
| Temporarily Impaired Securities:          |                   |            |                   |            |
| U.S. Government agencies and corporations | \$44,351          | \$622      | \$---             | \$---      |
| States and political subdivisions         | 9,358             | 216        | 482               | 3          |
| Other                                     | ---               | ---        | 133               | 172        |
| Total                                     | \$53,709          | \$838      | \$615             | \$175      |



The Company had 137 securities with a fair value of \$118,093 which were temporarily impaired at March 31, 2013. The total unrealized loss on these securities was \$2,539. Of the temporarily impaired total, four securities with a fair value of \$841 and an unrealized loss of \$137 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at March 31, 2013 for the reasons set out below.

U.S. Government agencies. The unrealized losses in this category of investments were caused by interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of these investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

States and political subdivisions. This category's unrealized losses are primarily the result of interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

Corporate debt securities. The Company's unrealized losses in corporate debt securities are related to interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

Other. The Company holds an investment in an LLC and a small amount of community bank stock. The value of these investments has been negatively affected by market conditions. Because the Company does not intend to sell these investments before recovery of amortized cost basis, the Company does not consider these investments to be other-than-temporarily impaired.

As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital and a percentage of qualifying assets. In addition, NBB is eligible to borrow from the FHLB with borrowings collateralized by qualifying assets, primarily residential mortgage loans and NBB's capital stock investment in the FHLB. Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at March 31, 2013, management did not consider there to be any impairment.

Management regularly monitors the credit quality of the investment portfolio. Changes in ratings are noted and follow-up research on the issuer is undertaken when warranted. Management intends to carefully follow any changes in bond quality.

#### Note 6: Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, "Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment." The amendments in this ASU apply to all entities that have indefinite-lived

intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other



comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

#### Note 7: Defined Benefit Plan

##### Components of Net Periodic Benefit Cost

|                                    | Pension Benefits<br>Three Months Ended<br>March, |        |
|------------------------------------|--|--------|
|                                    | 2013   | 2012   |
| Service cost                       | \$ 149   | \$ 117 |
| Interest cost                      | 154  | 185    |
| Expected return on plan assets     | (246 )   | (269 ) |
| Amortization of prior service cost | (25 )  | (25 )  |
| Recognized net actuarial loss      | 133  | 127    |
| Net Periodic Benefit Cost          | \$ 165   | \$ 135 |

##### 2013 Plan Year Employer Contribution

Without considering the prefunding balance, NBI's minimum required contribution to the National Bankshares, Inc. Retirement Income Plan (the "Plan") is \$815. Considering the prefunding balance, the 2013 minimum required contribution is \$0. The Company elected to contribute \$173 to the Plan during the three months ended March 31, 2013.

#### Note 8: Fair Value Measurements

The Company records fair value adjustments to certain assets and liabilities and determines fair value disclosures utilizing a definition of fair value of assets and liabilities that states that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Additional considerations come into play in determining the fair value of assets in markets that are not active.

The Company uses a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.

1 –

Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

3 –

The following describes the valuation techniques used by the Company to measure certain assets and liabilities recorded at fair value on a recurring basis in the financial statements.

### Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis.

| Description                               | Balance as of March 31, 2013 | Fair Value Measurements at March 31, 2013 Using                |   |   |
|---|------------------------------|--|---|---|
|   |                              | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Treasury                             | \$2,053                      | \$---  | \$2,053                                       | \$ ---                                    |
| U.S. Government agencies and corporations | 137,638                      | ---  | 137,638                                       | ---                                       |
| States and political subdivisions         | 33,583                       | ---  | 33,583  | ---                                       |
| Mortgage-backed securities                | 4,072                        | ---  | 4,072   | ---                                       |
| Corporate debt securities                 | 11,935                       | ---  | 11,935  | ---                                       |
| Other securities                          | 2,259                        | ---  | 2,259   | ---                                       |
| Total Securities Available for Sale       | \$191,540                    | \$---  | \$191,540                                     | \$ ---                                    |

| Description                               | Balance as of December 31, 2012 | Fair Value Measurements at December 31, 2012 Using             |   |   |
|---|---------------------------------|--|---|---|
|   |                                 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Treasury                             | \$2,073                         | \$---  | \$2,073                                       | \$ ---                                    |
| U.S. Government agencies and corporations | 129,564                         | ---  | 129,564                                       | ---                                       |
| States and political subdivisions         | 36,779                          | ---  | 36,779  | ---                                       |
| Mortgage-backed securities                | 4,569                           | ---  | 4,569   | ---                                       |
| Corporate debt securities                 | 14,575                          | ---  | 14,575  | ---                                       |
| Other securities                          | 2,255                           | ---  | 2,255   | ---                                       |
| Total Securities Available for Sale       | \$189,815                       | \$---  | \$189,815                                     | \$ ---                                    |

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements.

#### Loans Held for Sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at March 31, 2013 or December 31, 2012. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

#### Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that the Company will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement. Troubled debt restructurings are impaired loans. The measurement of loss associated with impaired loans may be based on either the observable market price of the loan, the present value of the expected cash flows or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, if an appraisal of

the real estate property is over 12 months old or if the real estate market is considered by management to be experiencing volatility, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal using observable market data, if the collateral is deemed significant. If the collateral is not deemed significant, the value of business equipment is based on the net book value on the borrower's financial statements. Likewise, values for inventory and accounts receivables collateral are based on the borrower's financial statement balances or aging reports (Level 3). Estimated losses on impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at March 31, 2013 and at December 31, 2012.

| Date              | Description                               | Balance | Carrying Value  |   |  |
|-------------------|---|---------|---|---|--|
|                   |   |         | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                   | Assets:                                   |         |   |   |  |
| March 31, 2013    | Impaired loans net of valuation allowance | \$ 722  | \$ ---  | \$ ---  | \$ 722   |
| December 31, 2012 | Impaired loans net of valuation allowance | 928     | ---   | ---   | 928  |

Impaired loans are measured quarterly for impairment. The Company employs the most applicable valuation method for each loan based on current information at the time of valuation.

The following tables present information about Level 3 Fair Value Measurements for March 31, 2013 and December 31, 2012.

| March 31, 2013 | Valuation Technique         | Unobservable Input | Range<br>(Weighted Average) |
|----------------|-----------------------------|--------------------|-----------------------------|
| Impaired loans | Discounted appraised value  | Selling cost       | 10.00%(1)                   |
| Impaired loans | Present value of cash flows | Discount rate      | 6.25% - 7.75%<br>(6.36%)    |

(1) Of the Company's impaired loans with specific allocations based on Level 3 inputs, only one loan was valued using fair value of collateral.

| December 31, 2012 | Valuation Technique        | Unobservable Input | Range<br>(Weighted Average) |
|-------------------|----------------------------|--------------------|-----------------------------|
| Impaired loans    | Discounted appraised value | Selling cost       | 0% - 10.00%<br>(2.00%)      |
| Impaired loans    |                            |                    |                             |

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|                |                             |   |                          |
|----------------|-----------------------------|---|--------------------------|
|                | Discounted appraised value  | Discount for lack of marketability and age of appraisal | 0% - 60.00%<br>(52.00%)  |
| Impaired loans | Present value of cash flows | Discount rate   | 6.00% - 7.50%<br>(6.28%) |

## Other Real Estate Owned

Other real estate owned are real estate assets acquired in full or partial satisfaction of a loan. At acquisition, other real estate owned assets are measured at fair value. If the assets are marketed for sale by an outside party, the acquisition-date fair value is discounted by selling costs; if the assets are marketed for sale by the Company, no reduction to fair value for selling costs is made. Subsequent to acquisition, the assets are measured at the lower of initial measurement or current fair value, discounted for selling costs as appropriate.

The fair value of an other real estate owned asset is determined by an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). If the appraisal is discounted either for age or because management considers the real estate market to be experiencing volatility, then the fair value is considered Level 3. Discounts for selling costs also result in measurement based on Level 3 inputs. Fair value adjustments are measured on a nonrecurring basis and are recorded in the period incurred as valuation allowances to other real estate owned, and expensed through noninterest expense.

The following table summarizes the Company's other real estate owned that was measured at fair value on a nonrecurring basis.

| Date              | Description  | Balance  | Carrying Value  |   |  |
|-------------------|--|----------|---|---|--|
|                   |  |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                   | Assets:  |          |   |   |  |
| March 31, 2013    | Other real estate owned net of valuation allowance | \$ 1,094 | \$ ---  | \$ ---  | \$ 1,094   |
| December 31, 2012 | Other real estate owned net of valuation allowance | 1,435    | ---   | ---   | 1,435  |

The following tables present information about Level 3 Fair Value Measurements for March 31, 2013 and December 31, 2012.

| March 31, 2013          | Valuation Technique        | Unobservable Input                                      | Range<br>(Weighted Average) |
|-------------------------|----------------------------|---|-----------------------------|
| Other real estate owned | Discounted appraised value | Selling cost  | 0.00%(1) – 9.95%<br>(2.28%) |
| Other real estate owned | Discounted appraised value | Discount for lack of marketability and age of appraisal | 0.00% - 30.90%<br>(4.94%)   |
| December 31, 2012       | Valuation Technique        | Unobservable Input                                      | Range<br>(Weighted Average) |
| Other real estate owned |                            | Selling cost  |                             |

|                         |                            |   |   |
|-------------------------|----------------------------|---|---|
|                         | Discounted appraised value |   | 0.00% <sup>(1)</sup> – 6.00%<br>(4.30%) |
| Other real estate owned | Discounted appraised value | Discount for lack of marketability and age of appraisal | 0.00% - 30.90%<br>(4.68%)               |

(1) The Company markets other real estate owned both independently and with local realtors. Properties marketed by realtors are discounted by selling costs. Properties that the Company markets independently are not discounted by selling costs.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments.

#### Cash and Due from Banks and Interest-Bearing Deposits

The carrying amounts approximate fair value.



## Securities

The fair value of securities, excluding restricted stock, is 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

The fair value of loans held for sale is based on commitments on hand from investors or prevailing market prices.

## Loans

Fair value for the loan portfolio is estimated on an account-level basis by discounting scheduled cash flows through the projected maturity for each loan. The calculation applies estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified by an estimate of the effect of economic conditions on lending.

Impaired loans are individually evaluated for fair value. Fair value for the Company's impaired loans is estimated by using either discounted cash flows or the appraised value of collateral. Any amount of principal balance that exceeds fair value is accrued in the allowance for loan losses. Assumptions regarding credit risk, cash flows and discount rates are determined within management's judgment, using available market information and specific borrower information. Discount rates for cash flow analysis are based on the loan's interest rate, and cash flows are estimated based upon the loan's historical payment performance and the borrower's current financial condition. Appraisals may be discounted for age, reasonableness, and selling costs.

## 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.

## Bank-Owned Life Insurance

Bank owned life insurance represents insurance policies on officers of the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

## 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 March 31, 2013 and December 31, 2012, 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 follow.

|                              | March 31, 2013     |   |   |  |                                  |
|------------------------------|--------------------|---|---|--|----------------------------------|
|                              | Carrying<br>Amount | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>Level 1 | Significant<br>Other<br>Observable<br>Inputs<br>Level 2 | Significant<br>Unobservable<br>Inputs<br>Level 3 | Total<br>Estimated<br>Fair Value |
| Financial Assets:            |                    |   |   |  |                                  |
| Cash and due from banks      | \$10,674           | \$10,674  | \$---   | \$---  | \$10,674                         |
| Interest-bearing deposits    | 107,176            | 107,176   | ---   | ---  | 107,176                          |
| Securities                   | 358,487            | ---   | 365,758   | ---  | 365,758                          |
| Mortgage loans held for sale | 313                | ---   | 313   | ---  | 313                              |
| Loans, net                   | 566,667            | ---   | ---   | 555,322  | 555,322                          |
| Accrued interest receivable  | 5,878              | 5,878   | ---   | ---  | 5,878                            |
| Bank-owned life insurance    | 20,690             | 20,690  | ---   | ---  | 20,690                           |
| Financial Liabilities:       |                    |   |   |  |                                  |
| Deposits                     | \$937,119          | \$667,227   | \$---   | \$ 263,814                                       | \$931,041                        |
| Accrued interest payable     | 146                | 146   | ---   | ---  | 146                              |

|                              | December 31, 2012  |   |   |  |                                  |
|------------------------------|--------------------|---|---|--|----------------------------------|
|                              | Carrying<br>Amount | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>Level 1 | Significant<br>Other<br>Observable<br>Inputs<br>Level 2 | Significant<br>Unobservable<br>Inputs<br>Level 3 | Total<br>Estimated<br>Fair Value |
| Financial Assets:            |                    |   |   |  |                                  |
| Cash and due from banks      | \$14,783           | \$14,783  | \$---   | \$---  | \$14,783                         |
| Interest-bearing deposits    | 96,597             | 96,597  | ---   | ---  | 96,597                           |
| Securities                   | 352,043            | ---   | 362,350   | ---  | 362,350                          |
| Mortgage loans held for sale | 2,796              | ---   | 2,796   | ---  | 2,796                            |
| Loans, net                   | 583,813            | ---   | ---   | 570,471  | 570,471                          |
| Accrued interest receivable  | 6,247              | 6,247   | ---   | ---  | 6,247                            |
| Bank-owned life insurance    | 20,523             | 20,523  | ---   | ---  | 20,523                           |
| Financial Liabilities:       |                    |   |   |  |                                  |
| Deposits                     | \$946,766          | \$669,028   | \$---   | \$ 272,820                                       | \$941,848                        |
| Accrued interest payable     | 139                | 139   | ---   | ---  | 139                              |



## Note 9: Components of Accumulated Other Comprehensive Loss

|  | Net<br>Unrealized<br>Gain<br>(Loss) on<br>Securities | Adjustments<br>Related to<br>Pension<br>Benefits | Accumulated<br>Other<br>Comprehensive<br>(Loss) |
|--|--|--|---|
| Balance at December 31, 2011   | \$ 2,646   | (3,967)  | (1,321)   |
| Unrealized holding losses on available for sale securities net of tax of (\$489) | (907)  | ---  | (907)   |
| Reclassification adjustment, net of tax of (\$15)                                | (29)   | ---  | (29)  |
| Balance at March 31, 2012  | \$ 1,710   | (3,967)  | (2,257)   |
| Balance at December 31, 2012   | 2,047  | (4,785)  | (2,738)   |
| Unrealized holding losses on available for sale securities net of tax of (\$487) | (903)  | ---  | (903)   |
| Reclassification adjustment, net of tax of (\$33)                                | (62)   | ---  | (62)  |
| Balance at March 31, 2013  | \$ 1,082   | \$ (4,785)                                       | \$ (3,703)                                      |

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
\$ in thousands, except per share data

The purpose of this discussion and analysis 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. Please refer to the financial statements and other information included in this report as well as the 2012 Annual Report on Form 10-K/A for an understanding of the following discussion and analysis.

Cautionary Statement Regarding Forward-Looking Statements

We make forward-looking statements in this Form 10-Q that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management's views and assumptions as of the date of this report. The words "believes," "expects," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends," or other similar words or terms are intended to identify forward-looking statements.

These forward-looking statements are based upon or are affected by factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. These factors include, but are not limited to, changes in:

- interest rates,
- general economic conditions,
- the legislative/regulatory climate,
- monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 ("EESA") the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and other financial reform legislation,
- unanticipated increases in the level of unemployment in the Company's trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company's trade area,
- the real estate market in the Company's trade area,
- the Company's technology initiatives,
- loss or retirement of key executives,
- adverse changes in the securities market, and
- applicable accounting principles, policies and guidelines.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained in this report. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report. This discussion and analysis should be read in conjunction with the description of our "Risk Factors" in Item 1A. of our 2012 Annual Report on Form 10-K/A.

The recession continues to impact the national economy as well as the Company's market. Signs of economic recovery are mixed with continued high unemployment and diminished real estate values. The Company's trade area contains a diverse economy that includes large public colleges and universities, which somewhat insulated the Company's market

from the dramatic declines in real estate values seen in some other areas of the country. Real estate values in the Company's market area saw moderate declines in 2009 and 2010 that appeared to stabilize in 2011 and 2012. If the economic recovery wavers or reverses, it is likely that unemployment will continue at higher-than-normal levels or rise in the Company's trade area. Because of the importance to the Company's markets of state-funded universities, cutbacks in the funding provided by the State as a result of the recession could also negatively impact employment. This could lead to an even higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company's business and professional customers. A slow economic recovery could have an adverse effect on all financial institutions, including the Company.

## 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 rates 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 Loan Losses

The allowance for loan losses is an accrual of estimated losses that have been sustained in our loan portfolio. The allowance is reduced by charge-offs of loans and increased by the provision for loan losses and recoveries of previously charged-off loans. The determination of the allowance is based on two accounting principles, Accounting Standards Codification ("ASC") Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss is reasonably estimable, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

Probable losses are accrued through two calculations, individual evaluation of impaired loans and collective evaluation of the remainder of the portfolio. Impaired loans are larger non-homogeneous loans for which there is a probability that collection will not occur according to the loan terms, as well as loans whose terms have been modified in a troubled debt restructuring. Impaired loans with an estimated impairment loss are placed on nonaccrual status.

### Impaired loans

Impaired loans are identified through the Company's credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan's fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral ("collateral method"), the present value of future cash flows ("cash flow method"), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is eminent and to loans for which the fair value of collateral is a more reliable estimate of fair value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

The Company bases collateral-method fair valuation upon the "as-is" value of independent appraisals or evaluations. Updated appraisals or evaluations are ordered when the loan becomes impaired if the appraisal or evaluation on file is more than twelve months old. Appraisals and evaluations are reviewed for propriety and reasonableness and may be discounted if the Company determines that the value exceeds reasonable levels. If an updated appraisal or evaluation has been ordered but has not been received by a reporting date, the fair value may be based on the most recent available appraisal or evaluation, discounted for age.

The appraisal or evaluation value for a collateral-dependent loan for which recovery is expected solely from the sale of collateral is reduced by estimated selling costs. Estimated losses on collateral-dependent loans, as well as any other impairment loss considered uncollectible, are charged against the allowance for loan losses. For loans that are not collateral dependent, the impairment loss is accrued in the allowance. Impaired loans with partial charge-offs are maintained as impaired until the remaining balance is satisfied. Smaller homogeneous impaired loans that are not troubled debt restructurings or part of a larger impaired relationship are collectively evaluated.



Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment with at least six months of consecutive timely payment performance, unless the impairment measurement indicates a loss. Troubled debt restructurings with impairment losses remain in nonaccrual status.

#### Collectively-evaluated loans

Non-impaired loans and smaller homogeneous impaired loans that are not troubled debt restructurings and not part of a larger impaired relationship are grouped by portfolio segments, and within those segments, by smaller loan classes. Loans within a segment or class have similar risk characteristics. Probable loss is determined by applying historical net charge-off rates as well as additional percentages for trends and current levels of quantitative and qualitative factors. Loss rates are calculated for and applied to individual classes and encompass losses for the current year and the previous year. Qualitative factors represented by delinquency rates, concentrations, loan quality, loan officers' experience, changes in lending policies and loan review are evaluated on a class level, with allocations based on the evaluation of trends and levels. Economic factors such as unemployment rates, bankruptcy rates and others are also evaluated, with standard allocations applied consistently to relevant classes.

The Company accrues additional estimated loss for criticized loans within each class and for loans designated high risk. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with terms that require only interest payments. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

#### Estimation of the allowance for loan losses

The estimation of the allowance involves analysis of internal and external variables, methodologies, assumptions and our judgment and experience. Key judgments used in determining the allowance for loan losses include internal risk rating determinations, market and collateral values, discount rates, loss rates, and our view of current economic conditions. These judgments are inherently subjective and our actual losses could be greater or less than the estimate. Future estimates of the allowance could increase or decrease based on changes in the financial condition of individual borrowers, concentrations of various types of loans, economic conditions or the markets in which collateral may be sold. The estimate of the allowance accrual determines the amount of provision expense and directly affects our financial results.

The estimate of the allowance for March 31, 2013 considered market and portfolio conditions during the first three months of 2013 as well as the elevated levels of delinquencies and net charge-offs in 2012. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 4 to the financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

#### Goodwill and Core Deposit Intangibles

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company’s most recent impairment test was performed in the fourth quarter of 2012. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. The Company opted not to perform the preliminary assessment. The Company’s goodwill impairment analysis considered three valuation techniques appropriate to the measurement. The first technique uses the Company’s market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to NBI; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to NBI. Each measure indicated that the Company’s fair value exceeded its book value, validating that goodwill is not impaired.

Certain key judgments were used in the valuation measurement. Goodwill is held by the Company’s bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company’s assets are comprised of the subsidiary bank’s equity, the Company’s market capitalization was used to estimate the Bank’s market capitalization. Other judgments include the assumption that the companies and transactions used as comparables for the second and third technique were appropriate to the estimate of the Company’s fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.

Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company amortizes intangible assets arising from branch transactions over their useful life. Core deposit 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 impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

#### Overview

National Bankshares, Inc. (“NBI”) is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg (“NBB”) and National

Bankshares Financial Services, Inc. (“NBFS”). NBB, which does business as National Bank from twenty-five office locations, is a community bank. NBB is the source of nearly all of the Company’s revenue. NBFS does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

NBI common stock is listed on the NASDAQ Capital Market and is traded under the symbol “NKSH.” National Bankshares, Inc. has been included in the Russell Investments Russell 3000 and Russell 2000 Indexes since June 29, 2009.

## Performance Summary

The following table presents NBI's key performance ratios for the three months ended March 31, 2013 and the year ended December 31, 2012. The measures for March 31, 2013 are annualized, except for basic earnings per share and fully diluted earnings per share.

|                                  | March 31, |   | December 31, |   |
|----------------------------------|-----------|---|--------------|---|
|                                  | 2013      |   | 2012         |   |
| Return on average assets         | 1.56      | % | 1.64         | % |
| Return on average equity         | 11.26     | % | 12.01        | % |
| Basic earnings per share         | \$ 0.61   |   | \$ 2.56      |   |
| Fully diluted earnings per share | \$ 0.60   |   | \$ 2.55      |   |
| Net interest margin (1)          | 4.28      | % | 4.38         | % |
| Noninterest margin (2)           | 1.46      | % | 1.36         | % |

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

The annualized return on average assets declined 8 basis points for the three months ended March 31, 2013 as compared to the year ended December 31, 2012, due primarily to growth in average assets. The annualized return on average equity declined 75 basis points for the same period, due in part to growth in average equity. Average equity tends to build in the months preceding the payment of dividends which have historically been paid semi-annually. The annualized net interest margin was 4.28% at the end of the first quarter of 2013, down 10 basis points from the 4.38% reported for the year ended December 31, 2012. The primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets. The annualized noninterest margin increased 10 basis points from the year ended December 31, 2012 primarily because of a decrease in noninterest income. Please refer to the discussion under noninterest expense for further information.

## Growth

NBI's key growth indicators are shown in the following table.

|                           | March 31,  |  | December 31, |  | Percent |     |
|---------------------------|------------|--|--------------|--|---------|-----|
|                           | 2013       |  | 2012         |  | Change  |     |
| Interest-bearing deposits | \$ 107,176 |  | \$ 96,597    |  | 10.95   | %   |
| Securities                | 359,901    |  | 352,043      |  | 2.23    | %   |
| Loans, net                | 566,667    |  | 583,813      |  | (2.94)  | ) % |
| Deposits                  | 937,119    |  | 946,766      |  | (1.02)  | ) % |
| Total assets              | 1,098,503  |  | 1,104,361    |  | (0.53)  | ) % |

A decrease from December 31, 2012 in loans of 2.94%, offset by a decline of 1.02% in customer deposits resulted in increased liquidity. Some of the funds were invested in securities, which increased 2.23% when compared to the amount at December 31, 2012, and the remainder increased interest-bearing deposits by 10.95%.



## Asset Quality

Key indicators of NBI's asset quality are presented in the following table.

|  | March 31,<br>2013 | March 31,<br>2012 | December<br>31, 2012 |   |   |
|--|-------------------|-------------------|----------------------|---|---|
| Nonperforming loans  | \$ 12,425         | \$ 5,328          | \$ 13,021            |   |   |
| Accruing restructured loans  | 5,732             | 3,742             | 2,005                |   |   |
| Loans past due 90 days or more, and still accruing   | 568               | 210               | 170                  |   |   |
| Other real estate owned  | 1,094             | 940               | 1,435                |   |   |
| Allowance for loan losses to loans   | 1.44              | % 1.38            | % 1.41               | % | % |
| Net charge-off ratio   | 0.50              | % 0.46            | % 0.49               | % | % |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 2.35              | % 1.07            | % 2.44               | % | % |
| Ratio of allowance for loan losses to nonperforming loans  | 66.73             | % 151.33          | % 64.12              | % | % |

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. The recent economic recession and slow recovery have contributed to levels of asset quality measures that are higher than normal for the Company. Accruing loans past due 90 days or more and the net charge-off ratio increased when compared to the amounts at March 31, 2012 and December 31, 2012. Nonperforming loans and other real estate owned increased from March 31, 2012 but declined slightly from December 31, 2012.

The Company's risk analysis determined an allowance for loan losses of \$8,291 at March 31, 2013, a decrease from \$8,349 at December 31, 2012. The provision for the three months ended March 31, 2013 was \$671, similar to the provision of \$672 for the same period in 2012. The ratio of the allowance for loan losses to loans was 1.44% at March 31, 2013, an increase from the 1.41% at December 31, 2012 and 1.38% at March 31, 2012. The increase in the net charge-off ratio contributed to the increase in the ratio of the allowance for loan losses as a percentage of loans from December 31, 2012. The Company continues to monitor risk levels within the loan portfolio.

Other real estate owned decreased \$341 from December 31, 2012 but increased \$154 from March 31, 2012. As of March 31, 2013, total properties approximating \$190 are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB's other real estate owned properties are regularly marketed and sold.

## Net Interest Income

The net interest income analysis for the three months ended March 31, 2013 and 2012 follows:

|  | March 31, 2013  |          |                    | March 31, 2012  |          |                    |  |  |
|--|-----------------|----------|--------------------|-----------------|----------|--------------------|--|--|
|  | Average Balance | Interest | Average Yield/Rate | Average Balance | Interest | Average Yield/Rate |  |  |
| Interest-earning assets:                     |                 |          |                    |                 |          |                    |  |  |
| Loans, net (1)(2)(3)(4)                      | \$583,912       | \$8,438  | 5.86 %             | \$585,348       | \$8,957  | 6.15 %             |  |  |
| Taxable securities                           | 174,542         | 1,539    | 3.58 %             | 152,563         | 1,589    | 4.19 %             |  |  |
| Nontaxable securities (1)(5)                 | 176,297         | 2,550    | 5.87 %             | 159,494         | 2,440    | 6.15 %             |  |  |
| Interest-bearing deposits                    | 99,216          | 58       | 0.24 %             | 110,901         | 71       | 0.26 %             |  |  |
| Total interest-earning assets                | \$1,033,967     | \$12,585 | 4.94 %             | \$1,008,306     | \$13,057 | 5.21 %             |  |  |
| Interest-bearing liabilities:                |                 |          |                    |                 |          |                    |  |  |
| Interest-bearing demand deposits             |                 |          |                    |                 |          |                    |  |  |
|  | \$448,817       | \$1,008  | 0.91 %             | \$408,262       | \$1,057  | 1.04 %             |  |  |
| Savings deposits                             | 70,647          | 8        | 0.05 %             | 62,602          | 9        | 0.06 %             |  |  |
| Time deposits                                | 275,857         | 663      | 0.97 %             | 309,940         | 1,051    | 1.36 %             |  |  |
| Total interest-bearing liabilities           | \$795,321       | \$1,679  | 0.86 %             | \$780,804       | \$2,117  | 1.09 %             |  |  |
| Net interest income and interest rate spread |                 | \$10,906 | 4.08 %             |                 | \$10,940 | 4.12 %             |  |  |
| Net yield on average interest-earning assets |                 |          | 4.28 %             |                 |          | 4.36 %             |  |  |

(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 two three-month periods presented.

(2) Included in interest income are loan fees of \$286 and \$198 for the three months ended March 31, 2013 and 2012, respectively.

(3) Nonaccrual loans are included in average balances for yield computations.

(4) Includes mortgage loans held for sale.

(5) Daily averages are shown at amortized cost.

The net interest margin for the three months ended March 31, 2013 decreased 8 basis points from the three months ended March 31, 2012. The decrease in interest rate spread was driven by a decline in the yield on earning assets of 27 basis points offset by a decline in the cost of interest-bearing liabilities of 23 basis points. Both loans and securities experienced a decline in yields. The 29 basis point decline in the yield on loans stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The yield on taxable securities was 61 basis points lower for the three months ended March 31, 2013, when compared with the same period in 2012, while the yield on nontaxable securities declined 28 basis points over the same period. The market yield for securities of a comparable term has declined over the past year, causing matured and called bonds to be replaced with lower yielding investments. The decline in the cost of interest-bearing liabilities came primarily from a 39 basis point reduction in the cost of time deposits when the three-month periods ended March 31, 2013 and March 31, 2012 are compared.

The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment. In the recent past, historically low interest rates caused funding costs to decline at a faster pace than the yield on earning assets. The decline in deposit pricing has begun to slow while competitive and market forces continue to pressure the yield on earning assets. The Company's cost of funding is more sensitive to interest rate changes than is the yield on

earning assets.

#### Provision and Allowance for Loan Losses

The provision for loan losses for the three month period ended March 31, 2013 was \$671, compared with \$672 for the three months of 2012. The ratio of the allowance for loan losses to total loans at the end of the first quarter of 2013 was 1.44%, which compares to 1.41% at December 31, 2012. The net charge-off ratio was 0.50% at March 31, 2013 and 0.49% at December 31, 2012. See "Asset Quality" for additional information.



## Noninterest Income

|                                | Three Months Ended |                   | Percent<br>Change |
|--------------------------------|--------------------|-------------------|-------------------|
|                                | March 31,<br>2013  | March 31,<br>2012 |                   |
| Service charges on deposits    | \$ 588             | \$ 631            | (6.81) %          |
| Other service charges and fees | 60                 | 49                | 22.45 %           |
| Credit card fees               | 740                | 794               | (6.80) %          |
| Trust fees                     | 289                | 326               | (11.35) %         |
| BOLI income                    | 188                | 200               | (6.00) %          |
| Other income                   | 150                | 99                | 51.52 %           |
| Realized securities gains      | 95                 | 53                | 79.25 %           |

Service charges on deposit accounts for the three months ended March 31, 2013 declined \$43 or 6.81% when compared with the same period in 2012.

Other service charges and fees includes charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Income for the three months ended March 31, 2013 increased \$11 from the same period in 2012, due to minor and routine fluctuations.

Credit card fees for the three months of 2013 decreased \$54, or 6.80%, when compared with the same period last year. The decrease was due to a lower volume of merchant transactions and credit card fees. Management anticipates that this category of noninterest income may be negatively affected by provisions included in the Dodd-Frank Wall Street Reform and Consumer Protection Act. As directed by the legislation, the Federal Reserve has adopted rules to control the level of debit card interchange fees. Financial institutions with less than \$10 billion in assets are exempt, however competitive forces may affect the Company's pricing structure. It is not yet known the extent to which these rules may impact the level of credit card fees or when that impact will occur.

Income from trust fees decreased 11.35% or \$37 from the \$326 earned in the same period of 2012. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions. Estate fees contributed to the amount recognized in 2012.

BOLI income decreased \$12 from March 31, 2012 to March 31, 2013.

Other income includes net gains from the sales of fixed assets, revenue from investment and insurance sales and other smaller miscellaneous components. Other income for the three months ended March 31, 2013 increased 51.52%, when compared with the three months ended March 31, 2012. These areas fluctuate with market conditions and because of competitive factors.

Net realized securities gains for the three months ended March 31, 2013 were \$95, as compared with \$53 for the same period in 2012. Net realized securities gains and losses are market driven and have resulted from calls of securities.

## Noninterest Expense

|                                   | Three Months Ended |                   | Percent<br>Change |
|-----------------------------------|--------------------|-------------------|-------------------|
|                                   | March 31,<br>2013  | March 31,<br>2012 |                   |
| Salaries and employee benefits    | \$ 2,940           | \$ 2,956          | (0.54) %          |
| Occupancy, furniture and fixtures | 432                | 397               | 8.82 %            |
| Data processing and ATM           | 393                | 392               | 0.26 %            |
| FDIC assessment                   | 136                | 109               | 24.77 %           |
| Credit card processing            | 552                | 572               | (3.50) %          |
| Intangibles amortization          | 271                | 271               | ---               |

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|                                      |     |     |       |   |
|--------------------------------------|-----|-----|-------|---|
| Net costs of other real estate owned | 75  | 48  | 56.25 | % |
| Franchise taxes                      | 258 | 162 | 59.26 | % |
| Other operating expenses             | 889 | 804 | 10.57 | % |

42

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Total noninterest expense increased \$235 or 4.11% when the three months ended March 31, 2013 are compared to the same period of 2012. Most of the increase was contributed by increases in franchise tax expense and other operating expense. Bank franchise tax expense for the three months ended March 31, 2013 increased \$96 or 59.26% over the same period in 2012. The tax is calculated based on equity. Bank franchise tax expense in 2012 benefitted from refunds of prior years' tax.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations and other expenses. Other operating expenses for the three months ended March 31, 2013 increased \$85 or 10.57% from same period in 2012. Contributing to the increase were higher marketing and business development expenses.

FDIC assessment expense for the three months ended March 31, 2013 increased \$27 or 24.77% over the same period for 2012. The calculation to determine the FDIC assessment, implemented in 2012, uses assets as the assessment base. Occupancy, furniture and fixtures expense increased 8.82%, from \$397 for the three months ended March 31, 2012 to \$432 as of March 31, 2013.

Salary and benefits expense was \$2,940 for the three months ended March 31, 2013, a decrease of 0.54% from \$2,956 for the three months ended March 31, 2012. No material items affected the decrease.

Credit card processing expense declined by 3.50% from the total for the three months ended March 31, 2012. This expense is driven by volume and other factors and is subject to a degree of variability.

Net costs of other real estate owned increased \$27 or 56.25% from the three months ended March 31, 2012 to \$75 for the three months ended March 31, 2013. This expense category includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market.

Data processing and ATM expense for the three months ended March 31, 2013 remained at a similar level to the amount for the three months ended March 31, 2012.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the past year, with no change in expense between the three month periods ended March 31, 2013 and March 31, 2012.

## Balance Sheet

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

|                                      | March 31,<br>2013 | December 31,<br>2012 | Percent<br>Change |    |
|--------------------------------------|-------------------|----------------------|-------------------|----|
| Assets                               |                   |                      |                   |    |
| Interest-bearing deposits            | \$ 99,216         | \$ 94,724            | 4.74              | %  |
| Securities available for sale        | 190,938           | 189,850              | (0.57)            | )% |
| Securities held to maturity          | 162,264           | 149,566              | 8.49              | %  |
| Loans, net                           | 574,030           | 579,817              | (1.00)            | )% |
| Total assets                         | 1,092,880         | 1,080,351            | 1.16              | %  |
| Liabilities and stockholders' equity |                   |                      |                   |    |
| Noninterest-bearing demand deposits  | \$ 137,864        | \$ 141,269           | (2.41)            | )% |
| Interest-bearing demand deposits     | 448,817           | 420,947              | 6.62              | %  |
| Savings deposits                     | 70,647            | 64,973               | 8.73              | %  |
| Time deposits                        | 275,857           | 298,797              | (7.68)            | )% |
| Stockholders' equity                 | 151,852           | 147,812              | 2.73              | %  |

## Securities

Management regularly monitors the quality of the securities portfolio, and management closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written

down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 5 Securities for additional information.

## Loans

|                                  | March 31,<br>2013 | December 31,<br>2012 | Percent<br>Change |     |
|----------------------------------|-------------------|----------------------|-------------------|-----|
| Real estate construction loans   | \$ 50,848         | \$ 50,313            | 1.06              | %   |
| Consumer real estate loans       | 139,694           | 143,262              | (2.49)            | ) % |
| Commercial real estate loans     | 294,578           | 304,308              | (3.20)            | ) % |
| Commercial non real estate loans | 35,478            | 37,349               | (5.01)            | ) % |
| Public sector and IDA            | 26,686            | 26,169               | 1.98              | %   |
| Consumer non real estate         | 28,581            | 31,714               | (9.88)            | ) % |
| Less: unearned income            | (907 )            | (953 )               | 4.83              | %   |
| Loans, net of unearned income    | \$ 574,958        | \$ 592,162           | (2.91)            | ) % |

The Company's loans net of unearned income decreased by \$17,204 or 2.91%, from \$592,162 at December 31, 2012 to \$574,958 at March 31, 2013. Growth in real estate construction, and public sector loans was offset by declines in other categories. Real estate construction loans grew by \$535 and public sector loans grew by \$517 from December 31, 2012 to March 31, 2013.

The 9.88% decline in consumer non real estate loans continues a trend that has been evident over the past several years. The availability of low cost dealer auto loans and other products, such as home equity lines of credit, make traditional consumer installment loans less attractive to customers.

Commercial real estate loans declined \$9,730 from December 31, 2012 while consumer real estate loans declined \$3,568 or 2.49%. Commercial non real estate loans decreased by \$1,871 or 5.01% from December 31, 2012. The declines are due to market, economic and competitive forces and are not the result of changes in lending policies.

The Company does not now, nor has it ever, offered certain types of higher-risk loans such as subprime loans, option ARM products, reverse mortgages or loans with initial teaser rates.

## Deposits

|                                     | March 31,<br>2013 | December 31,<br>2012 | Percent<br>Change |     |
|-------------------------------------|-------------------|----------------------|-------------------|-----|
| Noninterest-bearing demand deposits | \$ 144,815        | \$ 144,252           | 0.39              | %   |
| Interest-bearing demand deposits    | 449,992           | 455,713              | (1.26)            | ) % |
| Saving deposits                     | 72,420            | 69,063               | 4.86              | %   |
| Time deposits                       | 269,892           | 277,738              | (2.83)            | ) % |
| Total deposits                      | \$ 937,119        | \$ 946,766           | (1.02)            | ) % |

Total deposits decreased \$9,647, or 1.02% from \$946,766 at December 31, 2012 to \$937,119 at March 31, 2013. Increases in noninterest bearing demand deposits and savings deposits totaled \$3,920, or 1.84%. These increases were offset by a decline in interest bearing demand deposits and time deposits of \$13,567, or 1.85%, when March 31, 2013 is compared with December 31, 2012. Historically low rates have caused a migration from time deposits to other types of deposits. As longer-term certificates of deposit mature, customers are unwilling to commit their funds for extended periods at low interest rates. Time deposits do not include any brokered deposits.

## Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse sources of liquidity, including customer and purchased deposits, customer repayments of loan

principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank (“FHLB”) advances. At March 31, 2013, the bank did not have purchased deposits, discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

Liquidity from securities is restricted by accounting and business considerations. The securities portfolio is segregated into available-for-sale and held-to-maturity. The Company considers only securities designated available-for-sale for typical liquidity needs. Further, portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased or decreased liquidity from public funds deposits or discount window borrowings results in increased or decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and the amount of unpledged available-for-sale securities that are accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to utilize purchased deposits and the Federal Reserve discount window for liquidity needs. At March 31, 2013, the Company is considered well capitalized and does not have any restrictions on purchased deposits or the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At March 31, 2013, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities. It also tests the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At March 31, 2013, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At March 31, 2013, the loan to deposit ratio was 61.35%, slightly below the Company's internal target. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered to account for projected funding needs.

#### Capital Resources

Total stockholders' equity at March 31, 2013 was \$153,360, an increase of \$3,251, or 2.17%, from the \$150,109 at December 31, 2012. The Tier I and Tier II risk-based capital ratios at March 31, 2013 were 22.40% and 23.65%, respectively. Capital levels remain significantly above the regulatory minimum capital requirements of 4.0% for Tier I and 8.0% for Tier II capital.

#### Off-Balance Sheet Arrangements

In the normal course of business, NBB extends lines of credit and letters of credit to its customers. Depending on their needs, customers may draw upon lines of credit at any time in any amount up to a pre-approved limit. Standby letters of credit are issued for two purposes. Financial letters of credit guarantee payments to facilitate customer purchases. Performance letters of credit guarantee payment if the customer fails to complete a specific obligation. Historically, the full approved amount of letters and lines of credit has not been drawn at any one time. The Company has developed plans to meet a sudden and substantial funding demand. These plans include accessing a line of credit with a correspondent bank, borrowing from the FHLB, selling available for sale investments or loans and raising additional deposits.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. Mortgages must meet strict underwriting and documentation requirements for the sale to be completed. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of March 31, 2013. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the three months ended March 31, 2013, except for normal seasonal fluctuations in the total of mortgage loan commitments.

#### Contractual Obligations

The Company had no capital lease or purchase obligations and no long-term debt at March 31, 2013. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material at the end of the three months of 2013 and have not changed materially from those which were disclosed in the Company's 2012 Form 10-K/A.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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 to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2012 in the Company's 2012 Form 10-K/A.



#### Item 4. Controls and Procedures

The Company's management evaluated, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based upon that evaluation, the Company's principal executive officer and principal financial officer concluded that our disclosure controls and procedures were ineffective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including the Company's principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. Our principal executive officer and our principal financial officer based this conclusion on the fact that the Company identified, following the examination of the Company's subsidiary, The National Bank of Blacksburg (the "Bank"), by its primary federal regulator, a material weakness in the Company's internal control over classifying certain loans as impaired and nonaccrual within the appropriate regulatory timeframe. Additional information with respect to this issue is included in the discussion below.

#### Changes in Internal Control Over Financial Reporting

During March 2013, after management discovered the material weakness in its internal control over financial reporting described above, management implemented additional internal control procedures to ensure that more thorough review procedures are in place over the determination of classifying certain loans as impaired and nonaccrual. In addition, management changed the workflow of the procedures and has segregated duties among our lending department, credit administration department and accounting department to properly identify and disclose impaired loans. Also, following the examination of the Bank, and as a means of corrective action, the Company's management, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, established a task force of Company and Bank employees who reviewed all commercial relationships over \$500,000 in the Bank's portfolio to ensure compliance with Bank and regulatory policies relating to nonaccrual classification. This task force determined that the loans constituting the remaining portfolio of commercial relationships over \$500,000 were properly classified.

Because of the inherent limitations in all control systems, the Company believes that no system of controls, no matter how well designed and operated, can provide absolute assurance that all control issues have been detected.

## Part II Other Information

#### Item 1. Legal Proceedings

There are no pending or threatened legal proceedings to which the Company or any of its subsidiaries is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

#### Item 1A. Risk Factors

Please refer to the "Risk Factors" previously disclosed in Item 1A of our 2012 Annual Report on Form 10-K/A and the factors discussed under "Cautionary Statement Regarding Forward-Looking Statements" in Part I. Item 2 of this Form

10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

46

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Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Subsequent Events

From March 31, 2013, the balance sheet date of this Form 10-Q, through the date of filing the Form 10-Q with the Securities and Exchange Commission, there have been no material subsequent events that 1) provide additional evidence about conditions that existed on the date of the balance sheet, or 2) provide evidence about conditions that did not exist at the date of the balance sheet, but arose after the balance sheet date.

Item 6. Exhibits

See Index of Exhibits.

Signatures

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

NATIONAL BANKSHARES, INC.

Date: May 8, 2013

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

Date: May 8, 2013

/s/ David K. Skeens  
David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)

## Index of Exhibits

| Exhibit No. | Description  | Page No. in Sequential System  |
|-------------|--|--|
| 3(i)        | Amended and Restated Articles of Incorporation of National Bankshares, Inc.  | (incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)   |
| 3(ii)       | Amended By-laws of National Bankshares, Inc.   | (incorporated herein by reference to Exhibit 3(ii) of the Annual Report on Form 10K for fiscal year ended December 31, 2007)               |
| 4(i)        | Specimen copy of certificate for National Bankshares, Inc. common stock  | (incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)                |
| *10(iii)(A) | National Bankshares, Inc. 1999 Stock Option Plan   | (incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999) |
| *10(iii)(A) | Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and James G. Rakes                   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)      |
| *10(iii)(A) | Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and F. Brad Denardo                  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)      |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes               | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)  |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo              | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)  |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens              | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)  |
| *10(iii)(A) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)   |
| *10(iii)(A) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)   |
| *10(iii)(A) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)  |

\*10(viii)(A) Second Amendment, dated June 12, 2008, to The (incorporated herein by reference  
National Bank of Blacksburg Salary Continuation to Exhibit 10(iii)(A) of the Form  
Agreement for F. Brad Denardo 8K filed on June 12, 2008)

|              |  |   |
|--------------|--|---|
| *10(viii)(A) | Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008) |
| *10(iii)(A)  | Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                     |
| *10(viii)(A) | Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008) |
| *10(iii)(A)  | Third Amendment, dated January 20, 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                     |
| *10(iii)(A)  | Salary Continuation Agreement dated January 20, 2012 between The National Bank of Blacksburg and Bryson J. Hunter  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                     |
| 31(i)        | Section 906 Certification of Chief Executive Officer   | (included herewith)   |
| 31(ii)       | Section 906 Certification of Chief Financial Officer   | (included herewith)   |
| 32(i)        | 18 U.S.C. Section 1350 Certification of Chief Executive Officer  | (included herewith)   |
| 32(ii)       | 18 U.S.C. Section 1350 Certification of Chief Financial Officer  | (included herewith)   |
| 101          | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2013 is formatted in XBRL interactive data files: (i) Consolidated Statements of Income for the three months ended March 31, 2013, and 2012; (ii) Consolidated Balance Sheets at March 31, 2013 and December 31, 2012; (iii) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2013 and 2012; (iv) Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012; and (v) Notes to Financial Statements |   |

\* Indicates a management contract or compensatory plan.



Exhibit 31(i)

### CERTIFICATIONS

I, James G. Rakes, certify that:

1. I have reviewed this quarterly report on Form 10-Q 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;
  - (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 evaluation; 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: May 8, 2013

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

50

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Exhibit 31(ii)

### CERTIFICATIONS

I, David K. Skeens, certify that:

1. I have reviewed this quarterly report on Form 10-Q 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;
  - (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 evaluation; 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: May 8, 2013

/s/David K. Skeens  
David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)

51

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Exhibit 32 (i)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2013, I, James G. Rakes, Chairman, President and Chief Executive Officer (Principal 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-Q for the quarter ended March 31, 2013, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in such Form 10-Q for the quarter ended March 31, 2013, 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)  
May 8, 2013

Exhibit 32 (ii)

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2013, I, David K. Skeens, Treasurer and Chief Financial Officer (Principal Financial 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-Q for the quarter ended March 31, 2013, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in such Form 10-Q for the quarter ended March 31, 2013, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/David K. Skeens  
David K. Skeens  
Treasurer and  
Chief Financial Officer

(Principal Financial Officer)

May 8, 2013

52

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