

NATIONAL BANKSHARES INC

Form 10-Q

August 08, 2011

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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 June 30, 2011

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 August 1, 2011 |
|--------------------------------|-------------------------------|
| Common Stock, \$1.25 Par Value | 6,937,974                     |

(This report contains 45 pages)

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## NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q  
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Part I  
Financial Information

## Item 1. Financial Statements

National Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

|   | (Unaudited)      |                         |
|---|------------------|-------------------------|
|   | June 30,<br>2011 | December<br>31,<br>2010 |
| \$ in thousands, except per share data  |                  |                         |
| Assets  |                  |                         |
| Cash and due from banks   | \$ 13,113        | \$ 9,858                |
| Interest-bearing deposits   | 54,768           | 69,400                  |
| Securities available for sale, at fair value  | 190,674          | 184,907                 |
| Securities held to maturity (fair value approximates \$140,282 at June 30, 2011 and \$129,913 at December 31, 2010) | 136,399          | 131,000                 |
| Mortgage loans held for sale  | 248              | 2,460                   |
| Loans:  |                  |                         |
| Real estate construction loans  | 47,549           | 46,169                  |
| Real estate mortgage loans  | 171,818          | 173,533                 |
| Commercial and industrial loans   | 290,694          | 269,818                 |
| Loans to individuals  | 84,510           | 87,868                  |
| Total loans   | 594,571          | 577,388                 |
| Less unearned income and deferred fees  | (999)            | (945)                   |
| Loans, net of unearned income and deferred fees   | 593,572          | 576,443                 |
| Less allowance for loan losses  | (8,494)          | (7,664)                 |
| Loans, net  | 585,078          | 568,779                 |
| Premises and equipment, net   | 10,232           | 10,470                  |
| Accrued interest receivable   | 6,255            | 6,016                   |
| Other real estate owned, net  | 1,855            | 1,723                   |
| Intangible assets and goodwill  | 11,001           | 11,543                  |
| Other assets  | 25,234           | 26,082                  |
| Total assets  | \$ 1,034,857     | \$ 1,022,238            |
| Liabilities and Stockholders' Equity  |                  |                         |
| Noninterest-bearing demand deposits   | \$ 136,041       | \$ 131,540              |
| Interest-bearing demand deposits  | 384,329          | 365,040                 |
| Savings deposits  | 59,909           | 55,800                  |
| Time deposits   | 311,908          | 332,203                 |
| Total deposits  | 892,187          | 884,583                 |
| Accrued interest payable  | 237              | 257                     |
| Other liabilities   | 6,125            | 8,211                   |
| Total liabilities   | 898,549          | 893,051                 |
| Commitments and contingencies   | ---              | ---                     |

Stockholders' Equity

Preferred stock, no par value, 5,000,000 shares authorized;

none issued and outstanding

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Common stock of \$1.25 par value.

Authorized 10,000,000 shares; issued and outstanding 6,937,974 shares at June 30, 2011

and 6,933,474 shares at December 31, 2010

8,672

8,667

Retained earnings

128,129

123,161

Accumulated other comprehensive loss, net

(493)

(2,641)

Total stockholders' equity

136,308

129,187

Total liabilities and stockholders' equity

\$ 1,034,857

\$ 1,022,238

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three Months Ended June 30, 2011 and 2010  
(Unaudited)

| \$ in thousands, except per share data              | June 30,<br>2011 | June 30,<br>2010 |
|---|------------------|------------------|
| <b>Interest Income</b>                              |                  |                  |
| Interest and fees on loans                          | \$ 9,107         | \$ 9,260         |
| Interest on interest-bearing deposits               | 35               | 30               |
| Interest on securities – taxable                    | 1,713            | 1,466            |
| Interest on securities – nontaxable                 | 1,620            | 1,591            |
| Total interest income                               | 12,475           | 12,347           |
| <b>Interest Expense</b>                             |                  |                  |
| Interest on time deposits of \$100 or more          | 505              | 894              |
| Interest on other deposits                          | 1,841            | 1,956            |
| Total interest expense                              | 2,346            | 2,850            |
| Net interest income                                 | 10,129           | 9,497            |
| Provision for loan losses                           | 753              | 852              |
| Net interest income after provision for loan losses | 9,376            | 8,645            |
| <b>Noninterest Income</b>                           |                  |                  |
| Service charges on deposit accounts                 | 648              | 772              |
| Other service charges and fees                      | 59               | 54               |
| Credit card fees                                    | 827              | 760              |
| Trust income  | 307              | 261              |
| BOLI income   | 186              | 176              |
| Other income  | 77               | 89               |
| Realized securities gains (losses), net             | (14)             | 11               |
| Total noninterest income                            | 2,090            | 2,123            |
| <b>Noninterest Expense</b>                          |                  |                  |
| Salaries and employee benefits                      | 2,823            | 2,654            |
| Occupancy and furniture and fixtures                | 435              | 477              |
| Data processing and ATM                             | 429              | 349              |
| FDIC assessment                                     | 350              | 269              |
| Credit card processing                              | 646              | 584              |
| Intangible assets amortization                      | 271              | 271              |
| Net costs of other real estate owned                | 95               | 27               |
| Franchise taxes                                     | 215              | 242              |
| Other operating expenses                            | 761              | 824              |
| Total noninterest expense                           | 6,025            | 5,697            |
| Income before income taxes                          | 5,441            | 5,071            |
| Income tax expense                                  | 1,225            | 1,075            |
| Net Income  | \$ 4,216         | \$ 3,996         |





|   |    |           |    |           |
|---|----|-----------|----|-----------|
| Basic net income per share  | \$ | 0.61      | \$ | 0.58      |
| Fully diluted net income per share                                | \$ | 0.61      | \$ | 0.58      |
| Weighted average number of common<br>shares outstanding – basic   |    | 6,936,501 |    | 6,933,474 |
| Weighted average number of common<br>shares outstanding – diluted |    | 6,946,852 |    | 6,946,650 |
| Dividends declared per share                                      | \$ | 0.48      | \$ | 0.44      |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Six Months Ended June 30, 2011 and 2010  
(Unaudited)

| \$ in thousands, except per share data              | June 30,<br>2011 | June 30,<br>2010 |
|---|------------------|------------------|
| <b>Interest Income</b>                              |                  |                  |
| Interest and fees on loans                          | \$ 18,202        | \$ 18,436        |
| Interest on interest-bearing deposits               | 67               | 49               |
| Interest on securities – taxable                    | 3,375            | 2,909            |
| Interest on securities – nontaxable                 | 3,296            | 3,193            |
| Total interest income                               | 24,940           | 24,587           |
| <b>Interest Expense</b>                             |                  |                  |
| Interest on time deposits of \$100 or more          | 1,066            | 1,840            |
| Interest on other deposits                          | 3,659            | 3,989            |
| Total interest expense                              | 4,725            | 5,829            |
| Net interest income                                 | 20,215           | 18,758           |
| Provision for loan losses                           | 1,553            | 1,499            |
| Net interest income after provision for loan losses | 18,662           | 17,259           |
| <b>Noninterest Income</b>                           |                  |                  |
| Service charges on deposit accounts                 | 1,260            | 1,486            |
| Other service charges and fees                      | 117              | 151              |
| Credit card fees                                    | 1,560            | 1,426            |
| Trust income  | 553              | 530              |
| BOLI income   | 370              | 361              |
| Other income  | 168              | 143              |
| Realized securities losses, net                     | (4)              | (3)              |
| Total noninterest income                            | 4,024            | 4,094            |
| <b>Noninterest Expense</b>                          |                  |                  |
| Salaries and employee benefits                      | 5,727            | 5,510            |
| Occupancy and furniture and fixtures                | 858              | 968              |
| Data processing and ATM                             | 873              | 706              |
| FDIC assessment                                     | 696              | 532              |
| Credit card processing                              | 1,232            | 1,092            |
| Intangible assets amortization                      | 542              | 542              |
| Net costs of other real estate owned                | 229              | 60               |
| Franchise taxes                                     | 457              | 481              |
| Other operating expenses                            | 1,495            | 1,590            |
| Total noninterest expense                           | 12,109           | 11,481           |
| Income before income taxes                          | 10,577           | 9,872            |
| Income tax expense                                  | 2,337            | 2,107            |
| Net Income  | \$ 8,240         | \$ 7,765         |



|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Basic net income per share                                     | \$ | 1.19      | \$ | 1.12      |
| Fully diluted net income per share                             | \$ | 1.19      | \$ | 1.12      |
| Weighted average number of common shares outstanding – basic   |    | 6,935,148 |    | 6,933,474 |
| Weighted average number of common shares outstanding – diluted |    | 6,952,159 |    | 6,949,731 |
| Dividends declared per share                                   | \$ | 0.48      | \$ | 0.44      |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity  
Six Months Ended June 30, 2011 and 2010  
(Unaudited)

| \$ in thousands  | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Comprehensive<br>Income | Total     |
|--|-----------------|----------------------|--|-------------------------|-----------|
| Balances at December 31, 2009  | \$8,667         | \$113,901            | \$ (492 )  |                         | \$122,076 |
| Net income   | ---             | 7,765                | ---  | \$ 7,765                | 7,765     |
| Dividends \$0.44 per share   |                 | (3,051 )             |  |                         | (3,051 )  |
| Other comprehensive income, net of tax:                                      |                 |                      |  |                         |           |
| Unrealized gain on securities available for sale, net of income tax \$555    | ---             | ---                  | ---  | 1,032                   | ---       |
| Reclass adjustment, net of tax \$2   | ---             | ---                  | ---  | 3                       | ---       |
| Other comprehensive income, net of tax \$557                                 | ---             | ---                  | 1,035  | 1,035                   | 1,035     |
| Comprehensive income   | ---             | ---                  | ---  | \$ 8,800                | ---       |
| Balances at June 30, 2010  | \$8,667         | \$118,615            | \$ 543   |                         | \$127,825 |
| Balances at December 31, 2010  | \$8,667         | \$123,161            | \$ (2,641 )  |                         | \$129,187 |
| Net income   | ---             | 8,240                | ---  | \$ 8,240                | 8,240     |
| Dividends \$0.48 per share   |                 | (3,329 )             |  |                         | (3,329 )  |
| Stock options exercised  | 5               | 57                   | ---  |                         | 62        |
| Other comprehensive income, net of tax:                                      |                 |                      |  |                         |           |
| Unrealized gains on securities available for sale, net of income tax \$1,153 | ---             | ---                  | ---  | 2,141                   | ---       |
| Reclass adjustment, net of tax \$4   | ---             | ---                  | ---  | 7                       | ---       |
| Other comprehensive income, net of tax \$1,157                               | ---             | ---                  | 2,148  | 2,148                   | 2,148     |
| Comprehensive income   | ---             | ---                  | ---  | \$ 10,388               | ---       |
| Balances at June 30, 2011  | \$8,672         | \$128,129            | \$ (493 )  |                         | \$136,308 |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Six Months Ended June 30, 2011 and 2010  
(Unaudited)

| \$ in thousands  | June 30,<br>2011 | June 30,<br>2010 |
|--|------------------|------------------|
| <b>Cash Flows from Operating Activities</b>  |                  |                  |
| Net income   | \$8,240          | \$7,765          |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                  |                  |
| Provision for loan losses  | 1,553            | 1,499            |
| Depreciation of bank premises and equipment  | 414              | 446              |
| Amortization of intangibles  | 542              | 542              |
| Amortization of premiums and accretion of discounts, net                                       | 114              | 156              |
| Losses on sales and calls of securities available for sale, net                                | 11               | 4                |
| Gains on calls of securities held to maturity, net   | (7 )             | (1 )             |
| Losses and write-downs on other real estate owned  | 127              | 1                |
| Net change in:   |                  |                  |
| Mortgage loans held for sale   | 2,212            | (2,065 )         |
| Accrued interest receivable  | (239 )           | 227              |
| Other assets   | (272 )           | (777 )           |
| Accrued interest payable   | (20 )            | 20               |
| Other liabilities  | (2,086 )         | (486 )           |
| Net cash provided by operating activities  | 10,589           | 7,331            |
| <b>Cash Flows from Investing Activities</b>  |                  |                  |
| Net change interest-bearing deposits   | 14,632           | (20,581 )        |
| Proceeds from calls, principal payments, sales and maturities of securities available for sale | 28,416           | 32,416           |
| Proceeds from calls, principal payments and maturities of securities held to maturity          | 10,175           | 15,968           |
| Purchases of securities available for sale   | (30,996 )        | (24,625 )        |
| Purchases of securities held to maturity   | (15,611 )        | (19,534 )        |
| Collections of loan participations   | 21               | 2,671            |
| Loan originations and principal collections, net   | (19,199 )        | 1,851            |
| Proceeds from disposal of other real estate owned  | 1,029            | 484              |
| Recoveries on loans charged off  | 38               | 99               |
| Additions to bank premises and equipment   | (176 )           | (539 )           |
| Net cash used in investing activities  | (11,671 )        | (11,790 )        |
| <b>Cash Flows from Financing Activities</b>  |                  |                  |
| Net change in time deposits  | (20,295 )        | (16,106 )        |
| Net change in other deposits   | 27,899           | 23,331           |
| Cash dividends   | (3,329 )         | (3,051 )         |
| Stock options exercised  | 62               | ---              |
| Net cash provided by financing activities  | 4,337            | 4,174            |
| Net change in cash and due from banks  | 3,255            | (285 )           |
| Cash and due from banks at beginning of period   | 9,858            | 12,894           |
| Cash and due from banks at end of period   | \$13,113         | \$12,609         |





Supplemental Disclosures of Cash Flow Information

|  |         |         |
|--|---------|---------|
| Interest paid on deposits and borrowed funds | \$4,745 | \$5,809 |
| Income taxes paid                            | 1,382   | 2,881   |

Supplemental Disclosure of Noncash Activities

|   |       |       |
|---|-------|-------|
| Loans charged against the allowance for loan losses | \$761 | \$971 |
| Loans transferred to other real estate owned        | 1,288 | 1,529 |
| Unrealized gains on securities available for sale   | 3,305 | 1,592 |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
June 30, 2011  
(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 six months ended June 30, 2011 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 2010 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at [www.nationalbankshares.com](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. From 1999 to 2005, incentive stock options were granted annually to key employees of NBI and its subsidiaries. None have been granted since 2005. All of the outstanding stock options are vested. Because there have been no options granted in 2011 and all options were fully vested at December 31, 2008, there is no expense included in net income for the periods presented.

| Options                        | Shares  | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|---------|--|---|---------------------------------|
| Outstanding at January 1, 2011 | 109,500 | \$22.14                                  |   |                                 |
| Exercised                      | 4,500   | 14.09                                    |   |                                 |
| Forfeited or expired           | 26,000  | 22.08                                    |   |                                 |
| Outstanding June 30, 2011      | 79,000  | \$22.62                                  | 4.08  | \$259                           |
| Exercisable at June 30, 2011   | 79,000  | \$22.62                                  | 4.08  | \$259                           |

During the six months ended June 30, 2011, there were 4,500 shares exercised with an intrinsic value of \$46. During the first six months of 2010, there were no stock options exercised.

Note 3: 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 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 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 risk rated "classified" or "other assets especially mentioned." Impaired loans 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 10-K, "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.

Using a risk-based perspective, the Company determined five major categories, called segments, within the non-impaired portfolio. Characteristics of loans within portfolio segments are further analyzed to determine sub-groups. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. Subgroups with total balances exceeding 5% of Tier I and Tier II Capital are designated as loan classes.

The Company's segments consist of real estate secured consumer loans, non-real estate secured consumer loans, commercial real estate, commercial and industrial loans and construction, development and land loans. Consumer real estate is composed of loans to purchase or build a primary residence as well as equity lines secured by a primary residence. Consumer non-real estate contains credit cards, automobile and other installment loans, and deposit overdrafts. Commercial real estate is composed of all commercial loans that are secured by real estate. The commercial and industrial segment is commercial loans that are not secured by real estate. Construction, development and other land loans are composed of loans to developers of residential and commercial properties.

The Company's segments and classes are as follows:

|                                    |                              |
|------------------------------------|------------------------------|
| Consumer Real Estate               | Commercial Real Estate       |
| Equity lines                       | College housing              |
| Closed-end consumer real estate    | Office/Retail space          |
| Consumer construction              | Nursing homes                |
|                                    | Hotels                       |
| Consumer, Non-Real Estate          | Municipalities               |
| Credit cards                       | Medical professionals        |
| Consumer, general                  | Religious organizations      |
| Consumer overdraft                 | Convenience stores           |
|                                    | Entertainment and sports     |
| Commercial & Industrial            | Nonprofits                   |
| Commercial & industrial            | Restaurants                  |
|                                    | General contractors          |
| Construction, Development and Land | Other commercial real estate |
| Residential                        |                              |
| Commercial                         |                              |

Risk factors are analyzed for each class to estimate collective reserves. Factors include allocations for the historical charge-off percentage and changes in national and local economic and business conditions, in the nature and volume of the portfolio, in loan officers' experience and in loan quality. Increased allocations for the risk factors applied to each class are made for special mention and classified loans. The Company allocates additional reserves for "high risk" loans, determined to be junior lien mortgages, high loan-to-value loans and interest-only loans.

The Company collects and discloses data in compliance with accounting guidance in effect for the year disclosed. In December 2010, the Company adopted accounting guidance for disclosures on the allowance for loan losses. Information for periods prior to December 31, 2010 is presented according to guidance in effect for those periods, while disclosures required by the 2010 guidance are made for periods ending December 31, 2010 and forward.

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

|                            | Consumer<br>Real Estate | Consumer<br>Non-Real<br>Estate | Commercial<br>Real Estate | Commercial<br>&<br>Industrial | Construction,<br>Development<br>& Other<br>Land | Unallocated | Total    |
|----------------------------|-------------------------|--------------------------------|---------------------------|-------------------------------|---|-------------|----------|
| Allowance for Loan Losses  |                         |                                |                           |                               |   |             |          |
| Balance, December 31, 2010 |                         |                                |                           |                               |   |             |          |
|                            | \$ 1,059                | \$ 586                         | \$ 4,033                  | \$ 1,108                      | \$ 749  | \$ 129      | \$ 7,664 |
| Charge-offs                | (212 )                  | (150 )                         | (260 )                    | (137 )                        | ---   | ---         | (759 )   |
| Recoveries                 | 7                       | 28                             | ---                       | 1                             | ---   | ---         | 36       |
| Provision for loan losses  | 517                     | 19                             | 560                       | 376                           | (113 )  | 194         | 1,553    |
| Balance, June 30, 2011     |                         |                                |                           |                               |   |             |          |
|                            | \$ 1,371                | \$ 483                         | \$ 4,333                  | \$ 1,348                      | \$ 636  | \$ 323      | \$ 8,494 |

June 30, 2011

|                                       |          |        |          |          |        |        |          |
|---------------------------------------|----------|--------|----------|----------|--------|--------|----------|
| Allowance for Loan Losses             |          |        |          |          |        |        |          |
| Individually evaluated for impairment |          |        |          |          |        |        |          |
|                                       | \$ 215   | \$---  | \$ 413   | \$ 560   | \$ 3   | \$---  | \$ 1,191 |
| Collectively evaluated for impairment |          |        |          |          |        |        |          |
|                                       | 1,156    | 483    | 3,920    | 788      | 633    | 323    | 7,303    |
| Total                                 | \$ 1,371 | \$ 483 | \$ 4,333 | \$ 1,348 | \$ 636 | \$ 323 | \$ 8,494 |

Loans

|                                       |            |           |            |           |           |       |            |
|---------------------------------------|------------|-----------|------------|-----------|-----------|-------|------------|
| Individually evaluated for impairment |            |           |            |           |           |       |            |
|                                       | \$ 436     | \$---     | \$ 4,667   | \$ 587    | \$ 1,741  | \$--- | \$ 7,431   |
| Collectively evaluated for impairment |            |           |            |           |           |       |            |
|                                       | 111,848    | 30,780    | 358,754    | 39,630    | 45,129    | ---   | 586,141    |
| Total                                 | \$ 112,284 | \$ 30,780 | \$ 363,421 | \$ 40,217 | \$ 46,870 | \$--- | \$ 593,572 |

December 31, 2010

|                                       |          |        |          |          |        |        |          |
|---------------------------------------|----------|--------|----------|----------|--------|--------|----------|
| Allowance for Loan Losses             |          |        |          |          |        |        |          |
| Individually evaluated for impairment |          |        |          |          |        |        |          |
|                                       | \$ 27    | \$---  | \$ 565   | \$ 508   | \$ 100 | \$---  | \$ 1,200 |
| Collectively evaluated for impairment |          |        |          |          |        |        |          |
|                                       | 1,032    | 586    | 3,468    | 600      | 649    | 129    | 6,464    |
| Total                                 | \$ 1,059 | \$ 586 | \$ 4,033 | \$ 1,108 | \$ 749 | \$ 129 | \$ 7,664 |

Loans

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|   |           |          |           |          |          |       |           |
|---|-----------|----------|-----------|----------|----------|-------|-----------|
| Individually<br>evaluated for<br>impairment | \$505     | \$---    | \$5,151   | \$698    | \$2,437  | \$--- | \$8,791   |
| Collectively<br>evaluated for<br>impairment | 108,855   | 35,679   | 343,780   | 36,374   | 42,964   | ---   | 567,652   |
| Total loans                                 | \$109,360 | \$35,679 | \$348,931 | \$37,072 | \$45,401 | \$--- | \$576,443 |

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

|   | Six Months ended<br>June 30, |       | Year ended<br>December<br>31, |
|---|------------------------------|-------|-------------------------------|
|   | 2011                         | 2010  | 2010                          |
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees | 1.43%                        | 1.30% | 1.33%                         |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees(1)                  | 0.25%                        | 0.30% | 0.46%                         |

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

A summary of nonperforming assets follows:

|  | 2011    | June 30,<br>2010 | December<br>31,<br>2010 |
|--|---------|------------------|-------------------------|
| Nonperforming assets:  |         |                  |                         |
| Nonaccrual loans   | \$1,819 | \$7,167          | \$1,938                 |
| Restructured loans in nonaccrual   | 5,030   | ---              | 6,133                   |
| Total nonperforming loans  | 6,849   | 7,167            | 8,071                   |
| Other real estate owned, net   | 1,855   | 3,170            | 1,723                   |
| Total nonperforming assets   | \$8,704 | \$10,337         | \$9,794                 |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 1.46    | % 1.76           | % 1.69                  |
| Ratio of allowance for loan losses to nonperforming loans(1)   | 124.02  | % 105.39         | % 94.97                 |

(1) The Company defines nonperforming loans as total nonaccrual and restructured loans that are nonaccrual. Loans 90 days 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:

|   | 2011    | June 30,<br>2010 | December<br>31,<br>2010 |
|---|---------|------------------|-------------------------|
| Loans past due 90 days or more and still accruing   | \$572   | \$389            | \$1,336                 |
| Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees | 0.10    | % 0.07           | % 0.23                  |
| Accruing restructured loans   | 780     | ---              | 350                     |
| Impaired loans:   |         |                  |                         |
| Total impaired loans  | \$7,431 | \$6,586          | \$8,791                 |
| Impaired loans with no valuation allowance  | \$2,377 | \$---            | \$1,115                 |
| Impaired loans with a valuation allowance   | \$5,054 | \$6,586          | \$7,676                 |
| Valuation allowance   | (1,191) | (1,758)          | (1,200)                 |
| Impaired loans, net of allowance  | \$6,240 | \$4,828          | \$6,476                 |
| Average recorded investment in impaired loans(1)  | \$7,733 | \$6,927          | \$7,526                 |
| Income recognized on impaired loans   | \$24    | \$---            | \$17                    |

|   |       |       |       |
|---|-------|-------|-------|
| Amount of income recognized on a cash basis | \$--- | \$--- | \$--- |
|---|-------|-------|-------|

(1) Recorded investment includes principal and accrued interest.

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Nonaccrual loans that meet the Company's balance thresholds are designated as impaired. Total nonaccrual loans at June 30, 2011 were \$6,849, of which \$6,365 were impaired, compared with \$7,167 in nonaccruals at June 30, 2010, of which \$6,586 were impaired. As of December 31, 2010 nonaccruals totaled \$8,071, of which \$7,612 were impaired. No interest income was recognized on nonaccrual loans for the six months ended June 30, 2011 or June 30, 2010.

Loans past due greater than 90 days that continue to accrue interest totaled \$572 at June 30, 2011, compared with \$1,336 at December 31, 2010, and \$389 at June 30, 2010.

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

June 30, 2011

|   | Average<br>Recorded<br>Investment(1)<br>in Impaired<br>Loans | Unpaid<br>Principal<br>Balance of<br>Impaired<br>Loans | (A)<br>Total<br>Recorded<br>Investment(1)<br>in Impaired<br>Loans | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is No<br>Related<br>Allowance | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is a<br>Related<br>Allowance | Related<br>Allowance<br>for<br>Impaired<br>Loans | Interest<br>Income<br>Recognized |
|---|--|--|---|---|--|--|----------------------------------|
| Consumer Real<br>Estate(2)                  |  |  |   |   |  |  |                                  |
| Closed-end<br>Consumer Real<br>Estate       | \$543  | \$436  | \$436   | \$221   | \$215  | \$215  | \$1                              |
| Commercial Real<br>Estate(2)                |  |  |   |   |  |  |                                  |
| Hotels                                      | 3,475  | 3,452  | 3,452   | 283   | 3,169  | 142  | ---                              |
| Medical<br>Professionals                    | 65   | 75   | 75  | ---   | 75   | 75   | 7                                |
| College Housing                             | 196  | 367  | 367   | 367   | ---  | ---  | 3                                |
| Undeveloped<br>Land                         | 252  | 251  | 252   | 252   | ---  | ---  | 3                                |
| Other Commercial<br>Real Estate             | 1,131  | 773  | 777   | ---   | 777  | 196  | 10                               |
| Commercial &<br>Industrial(2)               |  |  |   |   |  |  |                                  |
| Commercial &<br>Industrial                  | 597  | 587  | 587   | ---   | 587  | 560  | ---                              |
| Construction,<br>Development and<br>Land(2) |  |  |   |   |  |  |                                  |
| Residential                                 | 1,474  | 1,490  | 1,490   | 1,256   | 234  | 3  | ---                              |
| Total                                       | \$7,733  | \$7,431  | \$7,436   | \$2,379   | \$5,057  | \$1,191  | \$24                             |

- (1) Recorded investment includes the unpaid principal balance and any accrued interest and deferred fees.
- (2) Only classes with impaired loans are shown.

December 31, 2010

|   | Average<br>Recorded<br>Investment(1) in<br>Impaired<br>Loans | Unpaid<br>Principal<br>Balance of<br>Impaired<br>Loans | (A)<br>Total<br>Recorded<br>Investment(1)<br>in Impaired<br>Loan | Recorded<br>Investment(1)<br>(A) for<br>Which<br>There is No<br>Related<br>Allowance | Recorded<br>Investment(1) in<br>(A) for<br>Which<br>There is a<br>Related<br>Allowance | Related<br>Allowance<br>for<br>Impaired<br>Loans | Interest<br>Income<br>Recognized |
|---|--|--|--|--|--|--|----------------------------------|
| Consumer Real<br>Estate(2)                  |  |  |  |  |  |  |                                  |
| Closed-end<br>Consumer Real<br>Estate       | \$ 337   | \$ 505   | \$ 505   | \$---  | \$ 505   | \$ 26  | \$ ---                           |
| Commercial Real<br>Estate(2)                |  |  |  |  |  |  |                                  |
| Office & Retail                             | 253  | ---  | ---  | ---  | ---  | ---  | ---                              |
| Hotel                                       | 2,767  | 3,509  | 3,509  | 287  | 3,222  | 267  | ---                              |
| Convenience<br>stores                       | 49   | 577  | 592  | 592  | ---  | ---  | 15                               |
| Other commercial<br>real estate             | 337  | 1,065  | 1,066  | ---  | 1,066  | 299  | 1                                |
| Commercial &<br>Industrial(2)               |  |  |  |  |  |  |                                  |
| Commercial &<br>Industrial                  | 1,183  | 698  | 698  | ---  | 698  | 508  | ---                              |
| Construction,<br>Development and<br>Land(2) |  |  |  |  |  |  |                                  |
| Residential                                 | 2,579  | 2,185  | 2,185  | ---  | 2,185  | 100  | ---                              |
| Commercial                                  | 21   | 252  | 253  | 253  | ---  | ---  | 1                                |
| Total                                       | \$7,526  | \$8,791  | \$8,808  | \$1,132  | \$7,676  | \$1,200  | \$ 17                            |

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

(2) Only classes with impaired loans are shown.

An analysis of past due and nonaccrual loans follows:

June 30, 2011

|   | 30 – 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | 90 Days<br>Past Due<br>and Still<br>Accruing | Nonaccruals<br>(Including<br>Impaired<br>Nonaccruals) |
|---|-----------------------------|--------------------------------|--|---|
| <b>Consumer Real Estate</b>               |                             |                                |  |   |
| Equity Lines                              | \$---                       | \$---                          | \$---  | \$ ---  |
| Closed-ended Consumer Real Estate         | 926                         | 734                            | 249  | 485   |
| Consumer Construction                     | ---                         | ---                            | ---  | ---   |
| <b>Consumer, Non-Real Estate</b>          |                             |                                |  |   |
| Credit Cards                              | 14                          | 7                              | 7  | ---   |
| Consumer General                          | 309                         | 25                             | 25   | ---   |
| Consumer Overdraft                        | 47                          | 18                             | 11   | ---   |
| <b>Commercial Real Estate</b>             |                             |                                |  |   |
| College Housing                           | 759                         | ---                            | ---  | ---   |
| Office/Retail                             | ---                         | ---                            | ---  | ---   |
| Nursing Homes                             | ---                         | ---                            | ---  | ---   |
| Hotels                                    | 622                         | 526                            | ---  | 3,451   |
| Municipalities                            | ---                         | ---                            | ---  | ---   |
| Medical Professionals                     | ---                         | ---                            | ---  | ---   |
| Religious Organizations                   | ---                         | ---                            | ---  | ---   |
| Convenience Stores                        | ---                         | ---                            | ---  | ---   |
| Entertainment and Sports                  | ---                         | ---                            | ---  | ---   |
| Nonprofits                                | ---                         | ---                            | ---  | ---   |
| Restaurants                               | ---                         | ---                            | ---  | ---   |
| General Contractors                       | 2                           | ---                            | ---  | ---   |
| Other Commercial Real Estate              | 1,200                       | 476                            | ---  | 476   |
| <b>Commercial and Industrial</b>          |                             |                                |  |   |
| Commercial and Industrial                 | ---                         | 208                            | 28   | 768   |
| <b>Construction, Development and Land</b> |                             |                                |  |   |
| Residential                               | ---                         | 302                            | ---  | 1,669   |
| Commercial                                | 129                         | 252                            | 252  | ---   |
| <b>Total</b>                              | <b>\$4,008</b>              | <b>\$2,548</b>                 | <b>\$572</b>                                 | <b>\$ 6,849</b>                                       |

December 31, 2010

|   | 30 – 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | 90 Days<br>Past Due<br>and Still<br>Accruing | Nonaccruals<br>(Including<br>Impaired<br>Nonaccruals) |
|---|-----------------------------|--------------------------------|--|---|
| <b>Consumer Real Estate</b>               |                             |                                |  |   |
| Equity Lines                              | \$69                        | \$---                          | \$---  | \$---   |
| Closed-ended Consumer Real Estate         | 1,868                       | 1,178                          | 612  | 783   |
| Consumer Construction                     | ---                         | ---                            | ---  | ---   |
| <b>Consumer, Non-Real Estate</b>          |                             |                                |  |   |
| Credit Cards                              | 67                          | 42                             | 29   | ---   |
| Consumer General                          | 518                         | 45                             | 37   | ---   |
| Consumer Overdraft                        | ---                         | ---                            | ---  | ---   |
| <b>Commercial Real Estate</b>             |                             |                                |  |   |
| College Housing                           | 224                         | 262                            | ---  | ---   |
| Office/Retail                             | ---                         | ---                            | ---  | ---   |
| Nursing Homes                             | ---                         | ---                            | ---  | ---   |
| Hotels                                    | ---                         | 802                            | ---  | 3,509   |
| Municipalities                            | ---                         | ---                            | ---  | ---   |
| Medical Professionals                     | ---                         | 181                            | ---  | ---   |
| Religious Organizations                   | ---                         | ---                            | ---  | ---   |
| Convenience Stores                        | 9                           | 577                            | 577  | ---   |
| Entertainment and Sports                  | ---                         | ---                            | ---  | ---   |
| Nonprofits                                | ---                         | ---                            | ---  | ---   |
| Restaurants                               | ---                         | ---                            | ---  | ---   |
| General Contractors                       | ---                         | 85                             | ---  | ---   |
| Other Commercial Real Estate              | 792                         | 136                            | ---  | 715   |
| <b>Commercial and Industrial</b>          |                             |                                |  |   |
| Commercial and Industrial                 | 740                         | 609                            | 81   | 879   |
| <b>Construction, Development and Land</b> |                             |                                |  |   |
| Residential                               | ---                         | 2,185                          | ---  | 2,185   |
| Commercial                                | 25                          | ---                            | ---  | ---   |
| <b>Total</b>                              | <b>\$4,312</b>              | <b>\$6,102</b>                 | <b>\$1,336</b>                               | <b>\$ 8,071</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 June 30, 2011 and 2010.

The following displays non-impaired loans by credit quality indicator:

June 30, 2011

|                                    | Pass      | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|------------------------------------|-----------|--------------------|---------------------------------------|
| Consumer Real Estate               |           |                    |                                       |
| Equity Lines                       | \$ 16,752 | \$ 19              | \$ 24                                 |
| Closed-end Consumer Real Estate    | 90,351    | 569                | 1,967                                 |
| Consumer Construction              | 2,166     | ---                | ---                                   |
| Consumer, Non-Real Estate          |           |                    |                                       |
| Credit Cards                       | 6,393     | ---                | 3                                     |
| Consumer General                   | 23,965    | 51                 | 103                                   |
| Consumer Overdraft                 | 265       | ---                | ---                                   |
| Commercial Real Estate             |           |                    |                                       |
| College Housing                    | 86,989    | 457                | 470                                   |
| Office/Retail                      | 75,650    | ---                | 3,769                                 |
| Nursing Homes                      | 14,455    | ---                | ---                                   |
| Hotels                             | 21,688    | 1,862              | 622                                   |
| Municipalities                     | 16,318    | ---                | ---                                   |
| Medical Professionals              | 16,267    | ---                | ---                                   |
| Religious Organizations            | 16,555    | ---                | ---                                   |
| Convenience Stores                 | 9,768     | ---                | ---                                   |
| Entertainment and Sports           | 7,176     | ---                | ---                                   |
| Nonprofits                         | 6,502     | ---                | ---                                   |
| Restaurants                        | 6,860     | ---                | ---                                   |
| General Contractors                | 5,159     | 17                 | 1,053                                 |
| Other Commercial Real Estate       | 66,602    | ---                | 1,115                                 |
| Commercial and Industrial          |           |                    |                                       |
| Commercial and Industrial          | 39,397    | 56                 | 177                                   |
| Construction, Development and Land |           |                    |                                       |
| Residential                        | 15,935    | ---                | 2,400                                 |
| Commercial                         | 23,697    | 2,962              | 135                                   |
| Total                              | \$568,310 | \$5,993            | \$11,838                              |

December 31, 2010

|                                    | Pass      | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|------------------------------------|-----------|--------------------|---------------------------------------|
| Consumer Real Estate               |           |                    |                                       |
| Equity Lines                       | \$ 15,735 | \$---              | \$ 119                                |
| Closed-ended Consumer Real Estate  | 85,313    | 731                | 2,969                                 |
| Consumer Construction              | 3,988     | ---                | ---                                   |
| Consumer, Non-Real Estate          |           |                    |                                       |
| Credit Cards                       | 6,446     | ---                | 14                                    |
| Consumer General                   | 28,730    | 392                | 94                                    |
| Consumer Overdraft                 | 3         | ---                | ---                                   |
| Commercial Real Estate             |           |                    |                                       |
| College Housing                    | 88,110    | 461                | 1,016                                 |
| Office/Retail                      | 60,540    | 3,500              | 848                                   |
| Nursing Homes                      | 28,018    | ---                | ---                                   |
| Hotel                              | 10,689    | 1,878              | 625                                   |
| Municipalities                     | 16,979    | ---                | ---                                   |
| Medical Professionals              | 17,111    | ---                | 181                                   |
| Religious Organizations            | 12,643    | ---                | ---                                   |
| Convenience Stores                 | 9,010     | 9                  | ---                                   |
| Entertainment and Sports           | 7,694     | ---                | ---                                   |
| Nonprofit                          | 6,421     | ---                | ---                                   |
| Restaurants                        | 6,740     | ---                | 153                                   |
| General Contractors                | 6,175     | ---                | 240                                   |
| Other Commercial Real Estate       | 63,679    | 111                | 951                                   |
| Commercial and Industrial          |           |                    |                                       |
| Commercial and Industrial          | 34,826    | 129                | 1,419                                 |
| Construction, Development and Land |           |                    |                                       |
| Residential                        | 25,760    | ---                | 2,633                                 |
| Commercial                         | 14,405    | ---                | 164                                   |
| Total                              | \$549,015 | \$7,211            | \$11,426                              |

#### 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. The Company has not purchased any participations in 2011. All participation loans previously 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.





## Note 4: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type as of June 30, 2011 are as follows:

|                                   | June 30, 2011   |                        |                         | Fair Values |
|-----------------------------------|-----------------|------------------------|-------------------------|-------------|
|                                   | Amortized Costs | Gross Unrealized Gains | Gross Unrealized Losses |             |
| Available for sale:               |                 |                        |                         |             |
| U.S. Treasury                     | \$2,012         | \$168                  | \$---                   | \$2,180     |
| U.S. Government agencies          | 103,012         | 1,070                  | 803                     | 103,279     |
| Mortgage-backed securities        | 8,848           | 622                    | ---                     | 9,470       |
| States and political subdivisions | 52,332          | 1,686                  | 145                     | 53,873      |
| Corporate                         | 16,877          | 699                    | 14                      | 17,562      |
| Federal Home Loan Bank stock      | 1,626           | ---                    | ---                     | 1,626       |
| Federal Reserve Bank stock        | 92              | ---                    | ---                     | 92          |
| Other securities                  | 2,719           | 35                     | 162                     | 2,592       |
| Total                             | \$187,518       | \$4,280                | \$1,124                 | \$190,674   |

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type as of June 30, 2011 are as follows:

|                                   | June 30, 2011   |                        |                         | Fair Values |
|-----------------------------------|-----------------|------------------------|-------------------------|-------------|
|                                   | Amortized Costs | Gross Unrealized Gains | Gross Unrealized Losses |             |
| Held to maturity:                 |                 |                        |                         |             |
| U.S. Government agencies          | \$18,056        | \$465                  | \$63                    | \$18,458    |
| Mortgage-backed securities        | 1,015           | 98                     | ---                     | 1,113       |
| States and political subdivisions | 114,670         | 3,616                  | 265                     | 118,021     |
| Corporate                         | 2,658           | 32                     | ---                     | 2,690       |
| Total                             | \$136,399       | \$4,211                | \$328                   | \$140,282   |

Information pertaining to securities with gross unrealized losses at June 30, 2011 and December 31, 2010, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|                                   | June 30, 2011                  |                 |                              |                 |
|-----------------------------------|--------------------------------|-----------------|------------------------------|-----------------|
|                                   | Less Than 12 Months Fair Value | Unrealized Loss | 12 Months or More Fair Value | Unrealized Loss |
| Temporarily impaired securities:  |                                |                 |                              |                 |
| U.S. Government agencies          | \$43,104                       | \$866           | \$---                        | \$---           |
| States and political subdivisions | 17,698                         | 320             | 2,697                        | 90              |
| Corporate                         | 1,986                          | 14              | ---                          | ---             |
| Other securities                  | ---                            | ---             | 142                          | 162             |
| Total                             | \$62,788                       | \$1,200         | \$2,839                      | \$252           |



|                                   | December 31, 2010                    |                    |                                    |                    |
|-----------------------------------|--------------------------------------|--------------------|------------------------------------|--------------------|
|                                   | Less Than 12 Months<br>Fair<br>Value | Unrealized<br>Loss | 12 Months or More<br>Fair<br>Value | Unrealized<br>Loss |
| Temporarily impaired securities:  |                                      |                    |                                    |                    |
| U.S. Government agencies          | \$64,850                             | \$3,127            | \$---                              | \$---              |
| States and political subdivisions | 65,640                               | 2,605              | 2,528                              | 258                |
| Corporate                         | 969                                  | 31                 | ---                                | ---                |
| Other securities                  | ---                                  | ---                | 247                                | 246                |
| Total                             | \$131,459                            | \$5,763            | \$2,775                            | \$504              |

The Company had 74 securities with a fair value of \$65,627 which were temporarily impaired at June 30, 2011. The total unrealized loss on these securities was \$1,452. Of the temporarily impaired total, five securities with a fair value of \$2,839 and an unrealized loss of \$252 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at June 30, 2011 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 and also a certain few ratings downgrades brought about by the impact of the economic downturn on states and political subdivisions. 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 and to ratings downgrades for a limited number of securities. 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, 2011, 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. Refer to "Securities" in this report for additional information.

Note 5: Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, "Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance significantly expands the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures, will be required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

In December 2010, the FASB issued ASU 2010-28, "Intangible – Goodwill and Other (Topic 350) – When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts." The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In December 2010, the FASB issued ASU 2010-29, "Business Combinations (Topic 805) – Disclosure of Supplementary Pro Forma Information for Business Combinations." The guidance requires pro forma disclosure for business combinations that occurred in the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma information should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. ASU 2010-29 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

The Securities Exchange Commission (SEC) issued Final Rule No. 33-9002, "Interactive Data to Improve Financial Reporting." The rule requires companies to submit financial statements in extensible business reporting language (XBRL) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB's Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02, "Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring." The amendments in this ASU clarify the guidance on a creditor's evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulty. The amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The

Company has adopted ASU 2011-02 and included the required disclosures in its consolidated financial statements. In April 2011, the FASB issued ASU 2011-03, "Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements." The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements. In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." This ASU is the result of joint efforts by the FASB and IASB to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and IFRSs. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, “Comprehensive Income (Topic 220) – Presentation of Comprehensive Income.” The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendments require that all non-owner changes in stockholders’ equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

#### Note 6: Defined Benefit Plan

##### Components of Net Periodic Benefit Cost:

|  | Pension Benefits<br>Six Months ended June<br>30, |        |
|--|--|--------|
|  | 2011   | 2010   |
| Service cost                                 | \$218  | \$200  |
| Interest cost                                | 352  | 344    |
| Expected return on plan assets               | (406 )   | (304 ) |
| Amortization of prior service cost           | (50 )  | (50 )  |
| Amortization of net obligation at transition | ---  | (6 )   |
| Recognized net actuarial loss                | 146  | 124    |
| Net periodic benefit cost                    | \$260  | \$308  |

##### 2011 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 \$816. Considering the prefunding balance, the 2011 minimum required contribution is \$0. The Company elected to contribute \$292 to the Plan in the quarter ended June 30, 2011.

##### 2010 Plan Year Employer Contributions

On March 29, 2011, NBI made an additional 2010 plan year contribution of \$2,500,000 to the Plan. Taken together with the \$585,047 the Company previously contributed to the defined benefit plan, the total 2010 plan year contribution was \$3,085,047. The Company accrues a liability for pension plan contributions based on actuarial calculations. The 2010 additional contribution was made from the accrued liability and had no material effect on the Company’s income statement, capital ratios or liquidity.



Note 7: 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 financial 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 financial 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 financial assets and liabilities measured at fair value on a recurring basis:

| Description                               | Balance as of June 30, 2011 | Fair Value Measurements at June 30, 2011 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                             | \$2,180                     | \$---  | \$2,180                                       | \$---                                     |
| U.S. Government agencies and corporations | 103,279                     | ---  | 103,279                                       | ---                                       |
| States and political subdivisions         | 53,873                      | ---  | 53,873  | ---                                       |
| Mortgage-backed securities                | 9,470                       | ---  | 9,470   | ---                                       |
| Corporate debt securities                 | 17,562                      | ---  | 17,562  | ---                                       |
| Other securities                          | 2,592                       | ---  | 2,592   | ---                                       |
| Total securities available for sale       | \$188,956                   | \$---  | \$188,956                                     | \$---                                     |

Fair Value Measurements at December 31, 2010 Using

| Description                               | Balance as of December 31, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---------------------------------|--|---|---|
| U.S. Treasury                             | \$2,183                         | \$---  | \$2,183                                       | \$---                                     |
| U.S. Government agencies and corporations | 88,152                          | ---  | 88,152  | ---                                       |
| States and political subdivisions         | 61,682                          | ---  | 61,682  | ---                                       |
| Mortgage-backed securities                | 11,379                          | ---  | 11,379  | ---                                       |
| Corporate debt securities                 | 17,680                          | ---  | 17,680  | ---                                       |
| Other securities                          | 2,062                           | ---  | 2,062   | ---                                       |
| Total securities available for sale       | \$183,138                       | \$---  | \$183,138                                     | \$---                                     |

Certain financial 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 financial 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 June 30, 2011 or December 31, 2010. 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. Fair value of the Company's impaired loans is measured based on the value of the collateral securing the loans. 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 or if an appraisal of the real estate property is over two years old, 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 financial assets that were measured at fair value on a nonrecurring basis at June 30, 2011 and at December 31, 2010.

| 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:                                   |          |   |   |  |
| June 30, 2011     | Impaired loans net of valuation allowance | \$ 3,863 | \$ ---  | \$ ---  | \$ 3,863   |
| December 31, 2010 | Impaired loans net of valuation allowance | 6,476    | ---   | ---   | 6,476  |



## Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell.

The following table summarizes the Company's other real estate owned that was measured at fair value on a nonrecurring basis at June 30, 2011 and at December 31, 2010.

| 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:  |         |   |   |  |
| June 30, 2011     | Other real estate owned<br>net of valuation<br>allowance | \$ 648  | \$ ---  | \$ ---  | \$ 648   |
| December 31, 2010 | Other real estate owned<br>net of valuation<br>allowance | 535     | ---   | ---   | 535  |

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

## Cash and Due from Banks, Interest-Bearing Deposits, and Federal Funds Sold

The carrying amounts approximate fair value.

## Securities

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

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

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

#### Deposits

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

## Accrued Interest

The carrying amounts of accrued interest approximate fair value.

## 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 June 30, 2011 and December 31, 2010, and, as such, the related fair values have not been estimated.

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

|                              | June 30, 2011   |                      | December 31, 2010 |                      |
|------------------------------|-----------------|----------------------|-------------------|----------------------|
|                              | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Financial assets:            |                 |                      |                   |                      |
| Cash and due from banks      | \$13,113        | \$13,113             | \$9,858           | \$9,858              |
| Interest-bearing deposits    | 54,768          | 54,768               | 69,400            | 69,400               |
| Securities                   | 327,073         | 330,956              | 315,907           | 314,820              |
| Mortgage loans held for sale | 248             | 248                  | 2,460             | 2,460                |
| Loans, net                   | 585,078         | 572,956              | 568,779           | 539,152              |
| Accrued interest receivable  | 6,255           | 6,255                | 6,016             | 6,016                |
| BOLI                         | 17,580          | 17,580               | 17,252            | 17,252               |
| Financial liabilities:       |                 |                      |                   |                      |
| Deposits                     | \$892,187       | 887,957              | \$884,583         | \$880,290            |
| Accrued interest payable     | 237             | 237                  | 257               | 257                  |

## 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 2010 Annual Report on Form 10-K 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," "project," "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 and the Federal Reserve Board, and the impact of any policies or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 (EESA) and other financial reform legislation, and political stalemates affecting fiscal policy,
- the effects of increased regulation of financial service companies and banks as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,
- 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 2010 Annual Report on Form 10-K.

The Company was not negatively impacted during the initial phases of the economic slowdown in late 2008. Its markets did not experience the dramatic declines in real estate values seen in some other areas of the country. In addition, the diverse economy of the Company's market area, including several large employers that are public colleges or universities, helped to insulate the Company from the worst effects of the recession. As the recession continued into 2009, real estate values in the Company's trade area declined moderately. In early 2010, the Company experienced an increasing level of nonperforming assets, including nonperforming loans and other real estate owned. If the economic recovery progresses slowly or is reversed, it is likely that unemployment will continue to 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 fear of layoffs caused reduced consumer demand for goods and services, which negatively impacts the Company's business and professional customers. In conclusion, 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 factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, the timing of events that would impact the transactions could change.

### Allowance for 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, FASB Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss

is reasonably estimable, and FASB 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.

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 (less cost to sell) of collateral, the present value of future cash flows, or observable market price. For loans that are not collateral dependent, the potential loss is accrued in the allowance. For collateral-dependent loans, the potential loss is charged off against the allowance, instead of being accrued. Impaired loans with partial charge-offs are maintained as impaired until it becomes evident that the borrower can repay the remaining balance of the loan according to the terms.

Non-impaired loans are grouped by portfolio segment and loan class. Loans within a segment or class have similar risk characteristics. Each segment and class is evaluated for probable loss by applying quantitative and qualitative factors, including net charge-off trends, delinquency rates, concentration trends and economic trends. 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 payments of interest-only required. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

The estimation of the accrual 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.

During 2009 and 2010, we experienced increases in delinquencies and net charge-offs due to deterioration of the housing market and the economy as a whole. The estimate of the allowance considered these market conditions in determining the accrual. However, given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 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. 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 NBB’s 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."

## Performance Summary

The following table presents NBI's key performance ratios for the six months ended June 30, 2011 and the year ended December 31, 2010. The measures for June 30, 2011 are annualized, except for basic net earnings per share and fully diluted net earnings per share.

|                                      | June 30,<br>2011 |   | December<br>31,<br>2010 |   |
|--------------------------------------|------------------|---|-------------------------|---|
| Return on average assets             | 1.63             | % | 1.57                    | % |
| Return on average equity             | 12.48            | % | 12.07                   | % |
| Basic net earnings per share         | \$1.19           |   | \$2.25                  |   |
| Fully diluted net earnings per share | \$1.19           |   | \$2.24                  |   |
| Net interest margin (1)              | 4.64             | % | 4.52                    | % |
| Noninterest margin (2)               | 1.59             | % | 1.49                    | % |

- (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 for the six months ended June 30, 2011 was 1.63%, 6 basis points higher than the 1.57% for the year ended December 31, 2010. The annualized return on average equity grew from 12.07% for the year ended December 31, 2010 to 12.48% for the six months ended June 30, 2011. The annualized net interest margin was a healthy 4.64% at the end of the second quarter of 2011, up 12 basis points from the 4.52% reported at year-end. The primary factor driving the increase in the net interest margin was the declining cost to fund interest-earning assets. Even though the Company had a modest decline in the yield on earning assets for the first six months of 2011, the decline was more than offset by declining interest expense.

The annualized noninterest margin increased from 1.49% at December 31, 2010 to 1.59% at June 30, 2011, primarily because of an increase in noninterest expense. Please refer to the discussion under noninterest expense for further information.

## Growth

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

|              | June 30, 2011 | December 31,<br>2010 | Percent<br>Change |   |
|--------------|---------------|----------------------|-------------------|---|
| Securities   | \$ 327,073    | \$ 315,907           | 3.53              | % |
| Loans, net   | 585,078       | 568,779              | 2.87              | % |
| Deposits     | 892,187       | 884,583              | 0.86              | % |
| Total assets | 1,034,857     | 1,022,238            | 1.23              | % |

Securities increased by \$11,166, or 3.53%, from \$315,907 at December 31, 2010 to \$327,073 at June 30, 2011. Net loans at June 30, 2011 were \$585,078, up \$16,299, or 2.87%, from \$568,779 at December 31, 2010. Deposits increased 0.86%, from \$884,583 at year-end to \$892,187 at June 30, 2011, or \$7,604. Total assets were \$1,022,238 at December 31, 2010 and were \$1,034,857 at June 30, 2011, an increase of \$12,619, or 1.23%.



## Asset Quality

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

|  | June 30, 2011 |        | June 30, 2010 |        | December 31, 2010 |       |   |
|--|---------------|--------|---------------|--------|-------------------|-------|---|
| Nonperforming loans  | \$            | 6,849  | \$            | 7,167  | \$                | 8,071 |   |
| Accruing restructured loans  |               | 780    |               | ---    |                   | 350   |   |
| Loans past due 90 days or more, and still accruing   |               | 572    |               | 389    |                   | 1,336 |   |
| Other real estate owned  |               | 1,855  |               | 3,170  |                   | 1,723 |   |
| Allowance for loan losses to loans   |               | 1.43   | %             | 1.30   | %                 | 1.33  | % |
| Net charge-off ratio   |               | 0.25   | %             | 0.30   | %                 | 0.46  | % |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned |               | 1.46   | %             | 1.76   | %                 | 1.69  | % |
| Ratio of allowance for loan losses to nonperforming loans  |               | 124.02 | %             | 105.39 | %                 | 94.97 | % |

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 higher than normal levels of some asset quality measures. Nonperforming loans were \$8,071 at December 31, 2010 and \$7,167 at June 30, 2010, but decreased to \$6,849 at June 30, 2011, a decline of \$1,222 or 15.14% from December 31, 2010 and \$318 or 4.44% from June 30, 2010. The net charge-off ratio also declined to 0.25% at June 30, 2011, from 0.46% at December 31, 2010 and 0.30% at June 30, 2010, while loans 90 days past due and still accruing declined \$764 from December 31, 2010 but increased \$183 from June 30, 2010.

The Company's risk analysis determined an allowance for loan losses of \$8,494 at June 30, 2011, resulting in a provision for the six months ended June 30, 2011 of \$1,553, an increase of \$54 or 3.6% from the \$1,499 from the same period in 2010. The ratio of the allowance for loan losses to loans increased to 1.43%, from 1.33% at December 31, 2010 and 1.30% at June 30, 2010. While charge-offs and nonperforming loans declined in the first half of 2011, the higher levels of the recent past were influential on the risk assessment calculation and contributed to the increase in the allowance and provision for loan losses. The Company continues to monitor risk levels within the loan portfolio and expects that any further increase in the allowance or provision for loan losses would be the result of the refinement of loss estimates and would not dramatically affect net income.

The total of other real estate owned was \$1,855 at June 30, 2011, up from \$1,723 at December 31, 2010 but down from \$3,170 at June 30, 2010. 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 six months ended June 30, 2011 and 2010 follows:

|                                    | June 30, 2011      |          |                           |   | June 30, 2010      |          |                           |   |
|------------------------------------|--------------------|----------|---------------------------|---|--------------------|----------|---------------------------|---|
|                                    | Average<br>Balance | Interest | Average<br>Yield/<br>Rate |   | Average<br>Balance | Interest | Average<br>Yield/<br>Rate |   |
| Interest-earning assets:           |                    |          |                           |   |                    |          |                           |   |
| Loans, net (1)(2)(3)               | \$586,421          | \$18,331 | 6.30                      | % | \$588,502          | \$18,629 | 6.38                      | % |
| Taxable securities                 | 155,881            | 3,375    | 4.37                      | % | 127,638            | 2,909    | 4.60                      | % |
| Nontaxable securities (1)(4)       | 164,249            | 5,098    | 6.26                      | % | 158,488            | 4,948    | 6.30                      | % |
| Interest-bearing deposits          | 56,792             | 67       | 0.24                      | % | 43,167             | 49       | 0.23                      | % |
| Total interest-earning assets      | \$963,343          | \$26,871 | 5.62                      | % | \$917,795          | \$26,536 | 5.83                      | % |
| Interest-bearing liabilities:      |                    |          |                           |   |                    |          |                           |   |
| Interest-bearing demand            |                    |          |                           |   |                    |          |                           |   |
| deposits                           | \$373,723          | \$2,036  | 1.10                      | % | \$312,061          | \$1,595  | 1.03                      | % |
| Savings deposits                   | 57,496             | 22       | 0.08                      | % | 53,001             | 24       | 0.09                      | % |
| Time deposits                      | 317,963            | 2,667    | 1.69                      | % | 361,107            | 4,210    | 2.35                      | % |
| Total interest-bearing liabilities | \$749,182          | \$4,725  | 1.27                      | % | \$726,169          | \$5,829  | 1.62                      | % |
| Net interest income and interest   |                    |          |                           |   |                    |          |                           |   |
| rate spread                        |                    | \$22,146 | 4.35                      | % |                    | \$20,707 | 4.21                      | % |
| Net yield on average               |                    |          |                           |   |                    |          |                           |   |
| interest-earning assets            |                    |          | 4.64                      | % |                    |          | 4.55                      | % |

- (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 six-month periods presented.
- (2) Included in interest income are loan fees of \$366 and \$399 for the six months ended June 30, 2011 and 2010, respectively.
- (3) Nonaccrual loans are included in average balances for yield computations.
- (4) Daily averages are shown at amortized cost.

The net interest margin increased 9 basis points from 4.55% to 4.64% for the six months ended June 30, 2011 and June 30, 2010, respectively. The increase in net interest margin was driven by a decline in the cost of interest-bearing liabilities of 35 basis points offset by a decline in the yield on interest earning assets of 21 basis points. The decline in the cost of interest-bearing liabilities came primarily from a 66 basis point reduction in the cost of time deposits offset by a 7 basis point increase in the cost of interest-bearing demand deposits, when the six-month periods ended June 30, 2011 and June 30, 2010 are compared. The 21 basis point decline in the yield on earning assets can be accounted for mostly by declines in both the yields on loans and on taxable securities. The yield on loans declined 8 basis points from June 30, 2010 to June 30, 2011, because of contractual repricing terms and the renegotiation of loan interest rates in response to competition. The yield on taxable securities was 23 basis points lower for the six months ended June 30, 2011, when compared with the same period in 2010. 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 Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment. In the recent past, with interest rates at historic lows, funding costs declined at a faster pace than 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 six month period ended June 30, 2011 was \$1,553, compared with \$1,499 for the first six months of 2010. The ratio of the allowance for loan losses to total loans at the end of the second quarter of 2011 was 1.43%, which compares to 1.33% at December 31, 2010. The net charge-off ratio was 0.25% at June 30, 2011 and 0.46% at December 31, 2010. See "Asset Quality" for additional information.

## Noninterest Income

|                                    | Six Months ended |               | Percent<br>Change |
|------------------------------------|------------------|---------------|-------------------|
|                                    | June 30, 2011    | June 30, 2010 |                   |
| Service charges on deposits        | \$ 1,260         | \$ 1,486      | (15.21 )%         |
| Other service charges and fees     | 117              | 151           | (22.52 )%         |
| Credit card fees                   | 1,560            | 1,426         | 9.40 %            |
| Trust fees                         | 553              | 530           | 4.34 %            |
| BOLI income                        | 370              | 361           | 2.49 %            |
| Other income                       | 168              | 143           | 17.48 %           |
| Realized securities gains (losses) | (4 )             | (3 )          | (33.33 )%         |

Service charges on deposit accounts totaled \$1,260 for the six months ended June 30, 2011. This is a 15.21% decrease, or \$226, when compared with the same period in 2010. The decline was in large part the result of a decrease of \$235 in fees from checking account overdrafts and fees for checks returned for insufficient funds, offset by minor increases in other service charges. The decline in fees for overdrafts and insufficient funds is representative of a nationwide trend of depositors managing bank accounts to reduce fees and service charges.

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 six months ended June 30, 2011 decreased \$34, or 22.52%, from the same period in 2010, due to minor and typical fluctuations.

Credit card fees for the first six months of 2011 were \$1,560. This was an increase of \$134, or 9.40%, when compared with the \$1,426 total reported for the same period last year. The increase was due to a higher volume of merchant transaction fees 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. This recent legislation directs the Federal Reserve Bank to control the level of debit card interchange fees. It is not yet known the extent to which the legislation may impact the level of credit card fees or when that impact will occur.

Income from Trust fees was \$553 for the six months ended June 30, 2011. This is a 4.34% increase from the \$530 earned in the same period of 2010. Trust income varies depending on the total assets held in Trust accounts, the type of accounts under management and financial market conditions. The increase in Trust income is attributable to a combination of all of these factors.

BOLI income did not change materially from June 30, 2010 to June 30, 2011.

Other income includes net gains from the sales of fixed assets, rent from foreclosed properties, revenue from investment and insurance sales and other smaller miscellaneous components. Other income for the six months ended June 30, 2011 was \$168. This represents an increase of \$25, or 17.48%, when compared with the six months ended June 30, 2010. These areas fluctuate with market conditions and because of competitive factors.

Realized securities losses for the six months ended June 30, 2011 were \$4, as compared with losses of \$3 for the same period in 2010. Net realized securities gains and losses are market driven and have resulted from calls of securities.

## Noninterest Expense

|                                   | Six Months ended |               | Percent<br>Change |
|-----------------------------------|------------------|---------------|-------------------|
|                                   | June 30, 2011    | June 30, 2010 |                   |
| Salaries and employee benefits    | \$ 5,727         | \$ 5,510      | 3.94 %            |
| Occupancy, furniture and fixtures | 858              | 968           | (11.36 )%         |
| Data processing and ATM           | 873              | 706           | 23.65 %           |

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|                                      |       |       |        |   |
|--------------------------------------|-------|-------|--------|---|
| FDIC assessment                      | 696   | 532   | 30.83  | % |
| Credit card processing               | 1,232 | 1,092 | 12.82  | % |
| Intangibles amortization             | 542   | 542   | ---    | % |
| Net costs of other real estate owned | 229   | 60    | 281.67 | % |
| Franchise taxes                      | 457   | 481   | (4.99) | % |
| Other operating expenses             | 1,495 | 1,590 | (5.97) | % |

Salary and benefits expense increased \$217, or 3.94%, from \$5,510 for the six months ended June 30, 2010 to \$5,727 for the six months ended June 30, 2011. Contributing to the increase was an increase of \$134 in fringe benefits, partially offset by a decline in net periodic pension expense of \$48 when the two periods are compared. Net periodic expense varies because of changes in the number of plan participants, the age of participants, the level of employer contributions, the investment performance of the plan trust and the interest rate environment. Please refer to Note 6 to the financial statements for additional information.

Occupancy, furniture and fixtures expense was \$858 for the six months ended June 30, 2011, a decrease of \$110, or 11.36%, from the same period last year. The decline is a result of general cost control measures with no significant decreases in any one factor.

Data processing and ATM expense was \$873 for the six months ended June 30, 2011, an increase of \$167, or 23.65%, from the six months ended June 30, 2010. Higher data processing expense in the first six months of 2011 is associated with increased costs for communications because of infrastructure upgrades.

The Federal Deposit Insurance Corporation Deposit Insurance Fund assessment for the six months ended June 30, 2011 was \$696. This compares with \$532 for the same period in 2010. The FDIC assessment is currently based on the level of deposits. The assessment reflects increases in deposits, as well as additional premiums associated with the increase in the FDIC insurance threshold to \$250. Given the severe impact of the economic downturn on some of the nation's banks, the Company has no assurance that the FDIC will not increase assessments on insured banks to maintain the integrity of the Deposit Insurance Fund.

Credit card processing expense was \$1,232 for the six months ended June 30, 2011, an increase of \$140, or 12.82%, from the total for the six months ended June 30, 2010. This expense is driven by volume and other factors such as merchant discount rates and is subject to a degree of variability.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the past year, and the expense was \$542 for both periods ended June 30, 2011 and 2010.

Net costs of other real estate owned have increased from \$60 for the six months ended June 30, 2010 to \$229 for the six months ended June 30, 2011. 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. Management anticipates that the total of other real estate owned and related expenses will increase as the slow economy and weak real estate market continue to impact borrowers.

Bank franchise taxes have declined 4.99%, from \$481 at June 30, 2010 to \$457 for the six months ended 2011.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage and charitable donations. Other operating expenses for the six months ended June 30, 2011 declined \$95 or 5.97% from \$1,590 to \$1,495 when compared with the same period in 2010. Management has made concerted efforts to control costs.

## Balance Sheet

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

|                                 | June 30, 2011 | December 31, 2010 | Percent Change |
|---------------------------------|---------------|-------------------|----------------|
| Assets                          |               |                   |                |
| Interest-bearing deposits       | \$ 56,792     | \$ 55,477         | 2.37 %         |
| Securities available for sale   | 188,044       | 161,504           | 16.43 %        |
| Securities held to maturity     | 132,469       | 128,028           | 3.47 %         |
| Mortgage loans held for sale    | 603           | 1,339             | (54.97) %      |
| Real estate construction loans  | 48,449        | 47,262            | 2.51 %         |
| Real estate mortgage loans      | 173,148       | 169,856           | 1.94 %         |
| Commercial and industrial loans | 279,047       | 276,829           | 0.80 %         |
| Loans to individuals            | 86,157        | 91,657            | (6.00) %       |

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|                                      |    |           |            |        |    |
|--------------------------------------|----|-----------|------------|--------|----|
| Total Assets                         |    | 1,022,196 | 989,952    | 3.26   | %  |
| Liabilities and stockholders' equity |    |           |            |        |    |
| Noninterest-bearing demand deposits  | \$ | 132,137   | \$ 122,818 | 7.59   | %  |
| Interest-bearing demand deposits     |    | 373,723   | 322,705    | 15.81  | %  |
| Savings deposits                     |    | 57,496    | 54,543     | 5.41   | %  |
| Time deposits                        |    | 317,963   | 352,887    | (9.90) | )% |
| Stockholders' equity                 |    | 133,182   | 129,003    | 3.24   | %  |

## Securities

The total amortized cost of securities available for sale and securities held to maturity at June 30, 2011 was \$323,917, and total fair value was \$330,956. At June 30, 2011, the Company held individual securities with a total fair value of \$65,627 that had a total unrealized loss of \$1,452. Of this total, securities with a fair value of \$2,839 and an unrealized loss of \$252 have been in a continuous loss position for 12 months or more. At June 30, 2011, there were no securities that management determined to be other-than-temporarily impaired.

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.

## Loans

|                                 | June 30, 2011 | December 31,<br>2010 | Percent<br>Change |    |
|---------------------------------|---------------|----------------------|-------------------|----|
| Commercial and industrial loans | \$ 290,694    | \$ 269,818           | 7.74              | %  |
| Real estate construction loans  | 47,549        | 46,169               | 2.99              | %  |
| Real estate mortgage loans      | 171,818       | 173,533              | (0.99)            | )% |
| Loans to individuals            | 84,510        | 87,868               | (3.82)            | )% |
| Total loans                     | \$ 594,571    | \$ 577,388           | 2.98              | %  |

The Company's total gross loans increased by \$17,183 or 2.98%, from \$577,388 at December 31, 2010 to \$594,571 at June 30, 2011. Commercial and industrial loans and real estate construction accounted for the majority of the increase, partially offset by a decrease in loans to individuals.

Commercial and industrial loans increased 7.74% from \$269,818 at December 31, 2010 to \$290,694 at June 30, 2011. The \$20,876 increase is due to higher loan demand.

The 3.82% decline in loans to individuals 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. Loans to individuals totaled \$84,510 at June 30, 2011. This compares with \$87,868 at year-end 2010.

Real estate construction loans grew 2.99% from \$46,169 at December 31, 2010 to \$47,549 at June 30, 2011. Real estate mortgage loans declined 0.99% or \$1,715 from \$173,533 at December 31, 2010 to \$171,818 at June 30, 2011.

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

## Deposits

|                                     | June 30, 2011 | December 31,<br>2010 | Percent<br>Change |    |
|-------------------------------------|---------------|----------------------|-------------------|----|
| Noninterest-bearing demand deposits | \$ 136,041    | \$ 131,540           | 3.42              | %  |
| Interest-bearing demand deposits    | 384,329       | 365,040              | 5.28              | %  |
| Saving deposits                     | 59,909        | 55,800               | 7.36              | %  |
| Time deposits                       | 311,908       | 332,203              | (6.11)            | )% |
| Total deposits                      | \$ 892,187    | \$ 884,583           | 0.86              | %  |

Total deposits increased \$7,604, or 0.86% from \$884,583 at December 31, 2010 to \$892,187 at June 30, 2011. Increases in all deposit categories other than time deposits totaled \$27,899, or 5.05%. These increases were offset by a decline in time deposits of \$20,295, or 6.11%, when June 30, 2011 is compared with December 31, 2010. 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 FHLB advances. At June 30, 2011, 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 June 30, 2011, 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 June 30, 2011, 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 June 30, 2011, 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 June 30, 2011, the loan to deposit ratio was 66.53%. 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 June 30, 2011 was \$136,308, an increase of \$7,121, or 5.51%, from the \$129,187 at December 31, 2010. The Tier I and Tier II risk-based capital ratios at June 30, 2011 were 18.66% and 19.90%, 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 June 30, 2011. 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 six months ended June 30, 2011, 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 June 30, 2011. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material at the end of the six months of 2011 and have not changed materially from those which were disclosed in the Company's 2010 Form 10-K.

## 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, 2010 in the Company's 2010 Form 10-K.

## Item 4. Controls and Procedures

The Company's management evaluated, 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 on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of June 30, 2011 to ensure that information required to be disclosed in the reports that the Company files or submits 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 that such information is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the 6 months ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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 2010 Annual Report on Form 10-K 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

The Company did not repurchase stock during the first six months of 2011.

Item 3. Defaults Upon Senior Securities

There were no defaults upon senior securities for the six months ended June 30, 2011.

Item 4. Reserved

Item 5. Other Information

Subsequent Events

From June 30, 2011, 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 August 3, 2011

/s/ James G. Rakes  
James G. Rakes  
President and  
Chief Executive Officer  
(Authorized Officer)

DATE August 3, 2011

/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<br>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) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and Theto National Bank of Blacksburg | (incorporated herein by reference to Exhibit 10 (iii) (A) of Form 10Q for the period ended September 30, 2002)                             |
| *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) | Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and Marilyn B. Buhyoff        | (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 National Bankshares, Inc. and Marilyn B. Buhyoff          | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)  |
| *10(iii)(A) |   |  |

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First Amendment, dated December 19, 2007, to(incorporated herein by reference  
The National Bank of Blacksburg Salaryto Exhibit 10(iii)(A) of the Form  
Continuation Agreement for James G. Rakes 8K filed on December 19, 2007)

\*10(iii)(A) First Amendment, dated December 19, 2007, to(incorporated herein by reference  
The National Bank of Blacksburg Salaryto Exhibit 10(iii)(A) of the Form  
Continuation Agreement for F. Brad Denardo 8K filed on December 19, 2007)

\*10(iii)(A) First Amendment, dated December 19, 2007, to(incorporated herein by reference  
National Bankshares, Inc. Salary Continuationto Exhibit 10(iii)(A) of the Form  
Agreement for Marilyn B. Buhyoff 8K filed on December 19, 2007)

\*10(viii)(A) Second Amendment, dated June 12, 2008, to The(incorporated herein by reference  
National Bank of Blacksburg Salary Continuationto 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(incorporated herein by reference The National Bank of Blacksburg Salaryto Exhibit 10(iii)(A) of the Continuation Agreement for James G. Rakes Annual Report on Form 10K for the fiscal year ended December 31, 2008)

\*10(viii)(A) Second Amendment, dated December 17, 2008, to(incorporated herein by reference The National Bank of Blacksburg Salaryto Exhibit 10(iii)(A) of the Continuation Agreement for Marilyn B. Buhyoff Annual Report on Form 10K for the fiscal year ended December 31, 2008)

\*10(viii)(A) Third Amendment, dated December 17, 2008, to(incorporated herein by reference The National Bank of Blacksburg Salaryto Exhibit 10(iii)(A) of the Continuation Agreement for F. Brad Denardo Annual Report on Form 10K for the fiscal year ended December 31, 2008)

31(i) Section 906 Certification of Chief Executive(included herewith)  
Officer

31(ii) Section 906 Certification of Chief Financial(included herewith)  
Officer

32(i) 18 U.S.C. Section 1350 Certification of Chief(included herewith)  
Executive Officer

32(ii) 18 U.S.C. Section 1350 Certification of Chief(included herewith)  
Financial Officer

\* 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: August 3, 2011

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

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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: August 3, 2011

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

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 June 30, 2011, I, James G. Rakes, 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 June 30, 2011, 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 June 30, 2011, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ James G. Rakes  
James G. Rakes  
President and Chief Executive Officer  
(Principal Executive Officer)  
August 3, 2011

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 June 30, 2011, 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 June 30, 2011, 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 June 30, 2011, 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)

August 3, 2011

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