NATIONAL BANKSHARES INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 For the Quarterly Period Ended September 30, 2006.

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OR THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________.

Commission file number 0-15204

NATIONAL BANKSHARES, INC.
(Exact name of Registrant as specified in its Charter)

Virginia	54-1375874
(State of incorporation)	(I.R.S. Employer Identification No.)

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

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

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

Large accelerated filer |_| Accelerated filer |X| Non-accelerated filer |_|

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

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 October 31, 2006
Common Stock, $1.25 Par Value	6,982,784

(This report contains 36 pages)

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q

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Part I
Financial Information
Item 1. Financial Statements

National Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

($ In thousands, except share and per share data)	(Unaudited) September 30, 2006
Assets	
Cash and due from banks	$14,598
Interest-bearing deposits	19,778
Securities available for sale, at fair value	161,876
Securities held to maturity (fair value approximates $104,478 at September 30, 2006 and $109,513 at December 31, 2005)	104,864
Mortgage loans held for sale	223
Loans:	
Real estate construction loans	30,929
Real estate mortgage loans	125,349
Commercial and industrial loans	213,197
Loans to individuals	129,151
Total loans	498,626
Less unearned income and deferred fees	(1,021)
Loans, net of unearned income and deferred fees	497,605
Less: allowance for loan losses	(5,252)
Loans, net	492,353
Bank premises and equipment, net	12,775
Accrued interest receivable	5,517
Other real estate owned, net	390
Intangible assets and goodwill, net	16,260
Other assets	16,363
Total assets	$844,997
Liabilities and Stockholders' Equity	
Noninterest-bearing demand deposits	$107,971
Interest-bearing demand deposits	210,022
Savings deposits	49,249
Time deposits	375,551
Total deposits	742,793

Other borrowed funds	76
Accrued interest payable	806
Other liabilities	3,519
Total liabilities	747,194

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Stockholders' Equity Preferred stock of no par value. Authorized 5,000,000 shares; none issued and outstanding	---
Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,988,484 shares in 2006 and 7,019,874 in 2005	8,736
Retained earnings	90,690
Accumulated other comprehensive (loss), net	(1,623)
Total stockholders' equity	97,803
Total liabilities and stockholders' equity	$844,997

See accompanying notes to the consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
Three Months Ended September 30, 2006 and 2005
(Unaudited)

($ In thousands, except share and per share data)	September 30, 2006
Interest income:	
Interest and fees on loans	$8,863
Interest on interest-bearing deposits	110
Interest on securities - taxable	1,878
Interest on securities - nontaxable	1,191
Total interest income	12,042
Interest expense:	
Interest on time deposits $100,000 or more	1,258
Interest on other deposits	3,425
Interest on borrowed funds	8

Total interest expense	4,691
Net interest income	7,351
Provision for loan losses	16
Net interest income after provision for loan losses	7,335
Noninterest income:	
Service charges on deposit accounts	862
Other service charges and fees	79
Credit card fees	617
Trust income	314
Other income	313
Realized securities gains (losses), net	47
Total noninterest income	2,232
Noninterest expense	
Salaries and employee benefits	2,866
Occupancy, furniture and fixtures	474
Data processing and ATM	294
Credit card processing	479
Intangibles amortization	284
Net costs of other real estate owned	2
Other operating expenses	997
Total noninterest expense	5,396
Income before income tax expense	4,171
Income tax expense	970
Net income	$3,201

Net income per share - basic	$0.46
- diluted	$0.46
Weighted average number of common shares outstanding - basic	6,993,891
- diluted	7,014,961
Dividends declared per share	$---

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
Nine Months Ended September 30, 2006 and 2005
(Unaudited)

($ In thousands, except share and per share data)	September 30, 2006	S
Interest income:		
Interest and fees on loans	$25,861	
Interest on interest-bearing deposits	370	
Interest on Federal funds sold	---	
Interest on securities - taxable	5,574	
Interest on securities - nontaxable	3,669	
Total interest income	35,474	
Interest expense:		
Interest on time deposits $100,000 or more	3,449	
Interest on other deposits	9,832	
Interest on borrowed funds	22	
Total interest expense	13,303	
Net interest income	22,171	
Provision for loan losses	40	
Net interest income after provision for loan losses	22,131	
Noninterest income:		
Service charges on deposit accounts	2,532	
Other service charges and fees	292	
Credit card fees	1,777	
Trust income	1,059	
Other income	830	
Realized securities gains (losses), net	13	
Total noninterest income	6,503	
Noninterest expense:		
Salaries and employee benefits	8,706	
Occupancy, furniture and fixtures	1,479	
Data processing and ATM	922	
Credit card processing	1,361	
Intangibles amortization	853	
Net costs of other real estate owned	16	
Other operating expenses	2,959	
Total noninterest expense	16,296	
Income before income tax expense	12,338	
Income tax expense	2,907	
Net income	$9,431	

Net income per share - basic	$1.35	
- diluted	$1.34	
Weighted average number of common shares outstanding - basic	7,006,767	
- diluted	7,031,118	
Dividends declared per share	$0.36	

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity
Nine Months Ended September 30, 2006 and 2005
(Unaudited)

($ In thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensiv Income
Balances, December 31, 2004	$8,797	$77,735	$556	
Net income	---	9,199	---	$9,1
Dividends ($0.35 per share)		(2,464)		
Other comprehensive loss, net of tax:				
Unrealized loss on securities available for sale, net of income tax $(327)	---	---	---	(6
Reclass adjustment, net of tax $(64)	---	---	---	(1
Other comprehensive loss	---	---	(726)	(7
Comprehensive income	---	---	---	$8,4
Exercise of stock options	11	95	---	-
Stock repurchased	(28)	(505)		
Balances, September 30, 2005	$8,780	$84,060	$(170)	-

Balances, December 31, 2005	$8,775	$84,610	$(1,446)	
Net income	---	9,431	---	$9,4
Dividends ($0.36 per share)		(2,524)		
Other comprehensive loss, net of tax:				
Unrealized loss on securities available for sale, net of income tax $(104)	---	---	---	(1
Reclass adjustment, net of tax $9	---	---	---	
Other comprehensive loss	---	---	(177)	(1
Comprehensive income	---	---	---	$9,2
Exercise of stock options	13	108	---	-
Stock repurchased	(52)	(935)		
Balances, September 30, 2006	$8,736	$90,690	$(1,623)	

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2006 and 2005
(Unaudited)

($In thousands)	September 30, 2006	S
Cash flows from operating activities:		
Net income	$9,431	
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	40	
Depreciation of bank premises and equipment	752	
Amortization of intangibles	853	
Amortization of premiums and accretion of discount, net	206	
(Gains)losses on disposal of fixed assets	(4)	
(Gains)losses on sales and calls of securities available for sale, net	25	
(Gains)losses on calls of securities held to maturity	(38)	
Losses and write downs on other real estate owned	10	
Increase(decrease) in:		
Mortgage loans held for sale	(223)	
Accrued interest receivable	(372)	
Other assets	(309)	
Increase in:		

Accrued interest payable	81
Other liabilities	691
Net cash provided by operating activities	$11,143
Cash flows from investing activities:	
Net (increase) decrease in interest-bearing deposits	(9,499)
Proceeds from calls, principal payments, sales and maturities of securities available for sale	11,748
Proceeds from calls, principal payments and maturities of securities held to maturity	6,448
Proceeds from the sale of securities held to maturity	823
Purchases of securities available for sale	(11,225)
Purchases of securities held to maturity	(2,458)
Purchases of loan participations	2,232
Collections of loan participations	(1,858)
Net (increase) in loans to customers	(5,737)
Acquisitions, net of cash received	---
Proceeds from disposal of other real estate owned	---
Recoveries on loans charged off	108
Purchase of bank premises and equipment	(720)
Proceeds from disposal of bank premises and equipment	5
Net cash (used in) investing activities	$(10,133)

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Cash flows from financing activities	
Net (decrease) in other deposits	$(25,319)
Net increase in time deposits	22,463
Net increase (decrease) in other borrowed funds	(281)
Stock options exercised	121
Cash dividends	(2,524)
Stock repurchased	(987)
Net cash (used in) provided by financing activities	$(6,527)
Net increase (decrease) in cash and due from banks	(5,517)
Cash and due from banks at beginning of period	20,115
Cash and due from banks at end of period	$14,598

Supplemental disclosure of cash flow information:	
Cash paid for interest	$13,222
Cash paid for income taxes	$2,372
Loans charged to the allowance for loan losses	$345
Loans transferred to other real estate owned	$24
Unrealized (losses) on securities available for sale	$(272)
Transactions related to acquisition of branches	
Increase in assets and liabilities:	

Investments	$---
Loans	$---
Deposits	$---
Fixed assets	$---

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
September 30, 2006
(Unaudited)
($ In thousands, except share and per share data)

Note (1)

The consolidated financial statements of National Bankshares, Inc. (Bankshares) and its wholly-owned subsidiaries, The National Bank of Blacksburg (NBB) and National Bankshares Financial Services, Inc. (NBFS), (the Company), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the nine months ended September 30, 2006 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 2005 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at www.nationalbankshares.com.

Note (2) Stock-Based Compensation

The Company adopted the National Bankshares, Inc. 1999 Stock Option Plan to give key employees of Bankshares and its subsidiaries an opportunity to acquire shares of National Bankshares, Inc. common stock. The purpose of the 1999 Stock Option Plan is to promote the success of Bankshares and its subsidiaries by providing an incentive to key employees that enhances the identification of their personal interest with the long term financial success of the Company and with growth in stockholder value. Under the 1999 Stock Option Plan, up to 500,000 shares of Bankshares common stock may be granted. The 1999 Stock Option Plan is administered by the Stock Option Committee, which is the NBI Board of Directors' Compensation Committee, made up entirely of independent directors of National Bankshares, Inc. The Stock Option Committee may determine whether options are incentive stock options or nonqualified stock options and may determine the other terms of grants, such as number of shares, term, a vesting schedule, and the exercise price. The 1999 Stock Option Plan limits the maximum term of any option granted to ten years, states that options may be granted at not less than fair market value on the date of the grant and contains certain other limitations on the exercisability of incentive stock options. The options generally vest 25% after one year, 50% after two years, 75% after three years and 100% after four years. On December 29, 2005, the Company's Board of Directors passed a resolution stating that all 142,000 previously granted, but unvested, stock options be immediately vested. The vesting was made subject to the provision that any shares of NBI common stock obtained by an option grantee by exercise of an option subject to accelerated vesting may not be sold or otherwise transferred prior to the expiration of the option's original vesting period. This action was taken to reduce the impact of the "Statement of Financial Accounting Standards No. 123R, Share-Based Payment" on the Company's earnings over the remaining vesting period of the stock options. At the discretion of the Stock Option Committee options may be awarded with the provision that they may be accelerated upon a change of control, merger, consolidation, sale or dissolution of National Bankshares, Inc. At September 30, 2006, there were 286,000 additional shares available for grant under the plan.

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

Options	Shares(1)	Weighted -Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 2006	172,500	$19.90		
Granted	---			
Exercised	(10,710)	$11.24		
Forfeited or expired	---			
Outstanding at September 30, 2006	161,790	$20.48	7.3	$447
Exercisable at September 30, 2006	161,790	$20.48	7.3	$447

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

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

($ In thousands, except per share data)	Nine months ended September 30, 2005	Three months ended September 30, 2005
Net income, as reported	$9,199	$3,054
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(110)	(37)
Pro forma net income	$9,089	$3,017
Earnings per share:		

Basic - as reported	$1.31	$0.44
Basic - pro forma	$1.30	$0.43
Diluted - as reported	$1.30	$0.43
Diluted - pro forma	$1.29	$0.43

During the nine months ended September 30, 2006, there were no stock options granted and 10,710 stock options were exercised with an intrinsic value of $129,000. For the nine months ended September 30, 2005 there were no stock options granted and 1,250 options were forfeited.

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

	For the periods ended September 30,		December 31,
	2006	2005	2005
($ In thousands, except % data)			
Balance at beginning of period	$5,449	$5,729	$5,729
Provision for loan losses	40	557	567
Loans charged off	(345)	(812)	(1,101)
Recoveries	108	146	254
Balance at the end of period	$5,252	$5,620	$5,449
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees	1.06%	1.13%	1.11%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees(1.)	0.06%	0.18%	0.17%
Ratio of allowance for loan losses to nonperforming loans(2.)	1,313.00%	2,239.04%	3,061.24%

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

	September 30,	December 31,

($ In thousands, except % data)	2006	2005	2005
Nonperforming Assets:			
Nonaccrual loans	$4	$251	$178
Restructured loans	---	---	---
Total nonperforming loans	---	251	178
Foreclosed property	390	429	376
Total nonperforming assets	$394	$680	$554
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	0.08%	0.14%	0.11%

	September 30,		December 31,
	2006	2005	2005
Loans Past due 90 days or more and still accruing	$495	$563	$546
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees	0.10%	0.11%	0.11%
Impaired loans:			
Total impaired loans	$---	$247	$174
Impaired loans with a valuation allowance	---	---	---
Valuation allowance	---	---	---
Impaired loans, net of allowance	---	---	---
Impaired loans with no valuation allowance	$---	$247	$174
Average recorded investment in impaired loans	$175	$299	$274
Income recognized on impaired loans	$---	$1	---
Amount of income recognized on a cash basis	$---	$1	$11

Nonaccrual loans excluded from impaired loan disclosure under FASB 114 at September 30, 2006 were $4.

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Note (4) Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for the sale by major security type as of September 30, 2006 are as follows:

	September 30, 2006		
($ In thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses
Available for sale:			
U.S. Treasury	$3,034	---	$125
U.S. Government Agencies and Corporations	28,791	---	282
State and political subdivisions	70,020	885	588
Mortgage-backed securities	26,072	6	468
Corporate debt securities	32,032	81	1,189
Federal Reserve Bank stock-restricted	92	---	---
Federal Home Loan Bank stock-restricted	1,822	---	---
Other securities	1,560	133	---
Total securities available for sale	$163,423	$1,106	$2,652

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type as of September 30, 2006 are as follows:

	September 30, 2006		
($ In thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses
Held to Maturity:			
U.S. Government Agencies and Corporations	$29,612	$2	$626

State and political subdivisions	53,467	805	223	
Mortgage-backed securities	2,598	9	30	
Corporate securities	19,187	197	520	
Total securities held to maturity	$104,864	$1,013	$1,399	

Information pertaining to securities with gross unrealized losses at September 30, 2006 and December 31, 2005, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	September 30, 2006			
	Less Than 12 Months		12 Months or More	
($ In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealiz Loss
U.S. Government agencies and corporations	$24,476	$127	$32,929	$
State and political subdivisions	13,875	92	26,525	
Mortgage-backed securities	10,455	101	15,298	
Corporate debt securities	6,493	124	31,335	1,
Total temporarily impaired securities	$55,299	$444	$106,087	$3,

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

The Company had 240 securities with a fair value of $161,386 which were temporarily impaired at September 30, 2006. The total unrealized loss on these securities was $4,051. Losses are attributed to interest rate movements. Credit quality of the securities portfolio is continuously monitored by management, and there is no present concern with that quality. The Company has the ability and intent to hold these securities until maturity. Therefore, the losses associated with these securities are considered temporary at September 30, 2006. All securities shown are above investment grade.

Note (5) Recent Accounting Pronouncements

In March 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets an amendment of FASB Statement 140" (Statement 156). Statement 156 amends Statement 140 with respect to separately recognized servicing assets and liabilities. Statement 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract and requires all servicing assets and liabilities to be initially measured at fair value, if practicable. Statement 156 also permits entities to subsequently measure servicing assets and liabilities using an amortization method or fair value measurement method. Under the amortization method, servicing assets and liabilities are amortized in proportion to and over the estimated period of servicing. Under the fair value measurement method, servicing assets are measured at fair value at each reporting date and changes in fair value are reported in net income for the period the change occurs. Adoption of Statement 156 is required as of the beginning of fiscal years beginning subsequent to September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements. The Company does not expect the adoption of Statement 156 at the beginning of 2007 to have a material impact.

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In September 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 expresses the SEC staff's views regarding the process of quantifying financial statement misstatements. These interpretations were issued to address diversity in practice and the potential under current practice for the build up of improper amounts on the balance sheet. SAB 108 expresses the SEC staff's view that a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the error on each financial statement and related financial statement disclosures and that prior year misstatements should be considered in quantifying misstatements in current year financial statements. SAB 108 also states that correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error arose and the fact that the errors had previously been considered immaterial. The SEC staff encourages early application of the guidance in SAB 108 for interim periods of the first fiscal year ending after November 15, 2006. The Company does not expect the implementation of SFAS 108 to have a material impact on its financial statements.

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140" (SFAS 155). SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The Statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. Finally, SFAS 155 amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not expect the implementation of SFAS 155 to have a material impact on its financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into certain servicing contracts. The Statement also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 permits an entity to choose between the amortization and fair value methods for subsequent measurements. At initial adoption, the Statement permits a one-time reclassification of available for sale securities to trading securities by entities with recognized servicing rights. SFAS 156 also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. This Statement is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not expect the implementation of SFAS 156 to have a material impact on its financial statements.

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In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company does not expect the implementation of SFAS 157 to have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan will be measured as the difference between plan assets at fair value and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Statement also requires additional disclosure in the notes to financial statements about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The Company is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employers' fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. If SFAS 158 had been implemented as of December 31, 2005, it would have resulted in decreases in accumulated comprehensive income of approximately $2,928. Comprehensive income as shown on the Consolidated Statement of Equity at December 31, 2005 would have been $7,494.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS 109. The Interpretation prescribes a recognition threshold and measurement principles for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not expect the implementation of FIN 48 to have a material impact on its financial statements.

Note (6) Defined Benefit Plan

Components of Net Periodic Benefit Cost

	Pension Benefits	
	Nine Months Ended September 30,	
($ in Thousands)	2006	2005
Service cost	$ 430	$ 420
Interest cost	486	459
Expected return on plan assets	(395)	(435)
Amortization of prior service cost	(10)	6
Recognized net actuarial loss	166	138
Amortization of transition cost	6	(9)
Net periodic benefit cost	$ 683	$ 579

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Employer Contributions

Bankshares expects to contribute a total of $952, paid in quarterly installments, to the pension plan for 2006. Contributions through September 30, 2006 totaled $524, and Bankshares anticipates making all required contributions prior to the end of 2006.

Note (7) Stock Split

Bankshares' Board of Directors approved a 2-for-1 stock split of Bankshares' common stock effective March 31, 2006. All per share information for prior periods presented has been restated to reflect the stock split.

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

Item 2. Management's Discussion and Analysis of Financial Condition

The purpose of this discussion is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the Company), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Refer to the financial statements and other information included in this report as well as the 2005 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

This Quarterly Report on Form 10-Q contains forward-looking statements as described in the Securities Exchange Act of 1934. The Company's actual results could differ materially from those set forth in the forward-looking statements.

Critical Accounting Policies

General

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

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

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

Core deposit intangibles

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

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

Overview

National Bankshares, Inc. (NBI) is a financial holding company located in Southwest Virginia. It conducts operations primarily through its full-service banking affiliate, the National Bank of Blacksburg. It also has one nonbanking affiliate, National Bankshares Financial Services, Inc., which offers investment and insurance products. Net income derived from the nonbanking affiliate is not significant at this time or in the foreseeable future. NBI is a community bank operation with total assets of approximately $845 million.

Company Activities in 2006

Until May 26, 2006, the Company operated two banking affiliates. On that date, its Bank of Tazewell County affiliate was merged into National Bank of Blacksburg. The National Bank of Blacksburg operates under the name of "National Bank". The merger of the Company's two banking affiliates offers bank customers more options in an expanded geographic area. It also provides operating efficiency through elimination of some duplicate functions.

The Company plans to install state of the art check imaging equipment in the fourth quarter of 2006. This equipment will greatly enhance efficiency in the area of document processing and provide certain advantages to the Company's banking customers.

Performance Summary

The following table shows NBI's key performance ratios for the periods ended September 30, 2006 and 2005 and December 31, 2005. Per share data has been adjusted to reflect the effects of the March 31, 2006 2-for-1 stock split.

	September 30, 2006	September 30, 2005	D
Return on average assets	1.51%	1.51%	
Return on average equity	13.34%	13.69%	
Net interest margin (1)	4.18%	4.53%	
Noninterest margin (2)	1.57%	1.82%	
Basic net earnings per share	$1.35	$1.31	
Fully diluted net earnings per share	$1.34	$1.30	

(1) Net Interest Margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets using a tax rate of 35%.

(2) Noninterest Margin: Noninterest income (including securities gains and losses) less noninterest expense (excluding the provision for bad debts and income taxes) divided by average year-to-date assets. This is a non-GAAP financial measure of the level of noninterest income and expense.

The return on average assets for the first nine months of 2006 and 2005 was 1.51%. The return on average equity experienced a decline.

The net interest margin declined by 35 basis points when compared with September 30, 2005, and it is down 27 basis points when compared to year-end 2005. This decrease was due to rising interest rates. Interest expense has continued to grow at a faster pace than interest income.

Growth

The following table shows NBI's key growth indicators:

	September 30, 2006	September 30, 2005	December 31, 2005
Securities	$266,740	$263,943	$272,541

Loans, net	492,353	493,240	487,162
Deposits	742,793	732,177	745,649
Total assets	844,997	828,907	841,498

At September 30, 2006, total assets were $844,997, an increase of $16,090, or 1.94%, when compared to September 30, 2005. Total assets increased $3,499, or 0.42%, when compared to December 31, 2005.

In order to reduce the compression of the net interest margin, management has exercised restraint when pricing large denomination time deposits. This approach has had a positive influence on profitability; however, it has slowed deposit growth. For a limited period during the third quarter of 2006, the Company's bank subsidiary offered two special time deposit products that were designed to attract new, smaller denomination deposits. These efforts helped to increase time deposit balances and total deposits for the quarter. (See also "Interest Expense").

Asset Quality

Key asset quality indicators are shown below:

	September 30, 2006	September 30,2005	Dec
Nonperforming loans	$ 4	$ 251	
Loans past due over 90 days	495	563	
Other real estate owned	390	429	
Allowance for loan losses to loans	1.06%	1.13%	
Net charge-off ratio	0.06%	0.18%	

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This data indicates that the level of nonperforming loans has declined, and at quarter-end there were no nonperforming loans. The level of loans past due 90 days or more has also declined. Asset quality remains excellent.

Net Interest Income

Net interest income for the nine months ended September 30, 2006 was $22,171, a decrease of $1,530 from the same period in 2005. This was the result of a decrease in the net interest margin.

A comparison of 2006 and 2005 indicates that the yield on earning assets increased by 18 basis points, while the cost to fund earning assets increased by 53 basis points. Together, these changes produced a decline in the net interest margin of 35 basis points.

In a rising interest rate environment, the net interest margin is primarily affected by the ability of the securities and loan portfolios to re-price upward. If these portfolios, which constitute the majority of the Company's earning assets, do not keep a reasonable pace with the upward re-pricing of liabilities used to fund these assets then the net interest margin will decline.

A comparison of yields on the securities and loan portfolios for the first nine months of 2006 and 2005 follows:

	For the period ended September 30, 2006	For the period ended September 30, 2005
Debit Securities	5.54%	5.61%
Loans	7.09%	6.76%

This table indicates that the yield on the securities portfolio declined 7 basis points from September 30, 2005 to September 30, 2006. The decline in yield occurred at the same time as the Company was required to pay more in interest for the liabilities that fund securities. The result negatively impacted net interest income and ultimately net income.

The loan portfolio yield increased by 33 basis points, significantly offsetting rising funding costs.

Assuming a stable interest rate environment, the net interest margin hould improve over time. Yields on earning assets, including securities and loans, will ultimately increase to reflect higher interest rates in the marketplace. This increase will help offset the more rapid increases in interest paid on deposits.

Securities re-pricing is affected by several factors including maturities, call features, sales, variable rate characteristics for some bonds and principal repayments. In this report, under the section "Interest Rate Sensitivity" is a schedule showing the amount of investments the Company expects will mature, call, re-price or pay down in the time periods specified. Potential sales are not factored in that table.

The Company does not anticipate selling a substantial number of securities in order to restructure the investment portfolio. To do so would likely result in losses caused by the decline in the current value of assets caused by rising interest rates. Any such losses could be avoided by holding the securities to maturity. In addition, the activation of call features is dependent upon the level of interest rates. Accordingly, the amount of bonds forecast to be called can vary from time to time.

Loan re-pricing is a function of scheduled repayments, prepayments, rate change frequency and other factors such as rate caps and rate floors. Since the re-pricings depend upon the contractual terms of individual loans, the Company's has little flexibility in controlling interest rate risk in this area. The table under "Interest Rate Sensitivity" shows the amount of loans expected to re-price.

Net Interest Income - Trends and Future Expectations

Starting in mid-2004 and continuing through 2006, the Federal Reserve Board initiated a series of interest rate increases. These increases were designed to restore interest rates to historically more typical levels and to prevent inflation. Rate increases occurred at regular intervals, each at 25 basis points.

In its August 2006 meeting, the Federal Reserve Bank declined to raise interest rates. It is not known at this point in time whether this halt is permanent or temporary. A cessation of rate increases would eventually have a positive impact on the Company's net interest margin.

Interest Expense

Interest expense for the nine months ended September 30, 2006 was $13,303, an increase of $3,218, or 31.9%, from the same period the prior year. As previously discussed, rising interest rates have been the major contributor to this increase.

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

As previously noted, during the third quarter the Company initiated two special time deposit offers in an effort to procure additional deposits. These efforts were successful. Some new time deposits were acquired and some existing deposits migrated to the special products. The Company's trade area continues to be highly competitive.

Provision and Allowance for Loan Losses

The provision for loan losses for the nine-month period ended September 30, 2006 was $40, a $517 decrease from the same period ended September 30, 2005. The ratio of the allowance for loan losses to total loans at the end of the first nine months of 2006 was 1.06%, which compares to 1.13% at the same period last year. The net charge-off ratio at September 30, 2006 was 0.06%, and it was 0.18% at September 30, 2005.

The Company regularly reviews asset quality and re-evaluates the allowance for loan losses. An appropriate provision and allowance for loan losses is established for the bank, depending upon the quality of its loan portfolio. Because of the continued excellent overall quality of the loan portfolio and somewhat slower loan growth, it is management's judgment that the decrease in the provision for loan losses is justified and the allowance is appropriate and adequate. (See "Allowance for Loan Losses" under "Critical Accounting Policies".)

Noninterest Income

	September 30, 2006	September 30, 2005
Service charges on deposits	$2,532	$2,273
Other service charges and fees	292	224
Credit card fees	1,777	1,625
Trust fees	1,059	1,062
Other income	830	408
Realized securities gains (losses)	13	(5)

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

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

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

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

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

Service charges on deposits were $2,532 at September 30, 2006, an increase of $259 or 11.4%. In early 2005 the Company increased its charge for each overdrawn item, and the amount of daily maximum charges was also increased.

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

- o Fees for the issuance of official checks
- o Safe deposit box rent
- o Income from the sale of customer checks
- o Income from the sale of credit life and accident and health insurance

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

Other service charges and fees at September 30, 2006 were $292, as compared with $224 for the same period the prior year. Of the $68 increase, approximately $10 was due to increases in fees associated with cashing income tax refund checks. Another $16 came from increased fees for letters of credit. The remainder of the increase was in the safe deposit box, and credit life insurance categories.

Credit card fees consist of three types of revenues.

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

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

Credit card fees increased by $152 or 9.4% when September 30, 2006 and September 30, 2005 are compared. The increase was attributable to volume.

Trust income is somewhat dependent upon market conditions and the number of estate accounts being handled at any given point in time. Financial market conditions, which affect the value of trust assets managed, can vary, leading to fluctuations in the related income. Over the past few years and into 2006, the financial markets have experienced a degree of volatility. Income from estates is also unpredictable. Trust income for the first nine months of 2006 was $1,059, compared to $1,062 from the previous year.

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

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

o Revenue from investment and insurance sales

Given the nature of the items included in this category, trends or patterns are not identifiable. Other income increased $422 when September 30, 2006 and September 30, 2005 are compared. Of the $422 change, approximately $409 was attributable to increases in cash value associated with bank owned life insurance policies.

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

Realized gains and losses were $13 for the period ended September 30, 2006. The net gain was due to securities sold or called offset by write downs in the Company's investment in certain limited liability companies (LLC's).

Noninterest Expense

	September 30, 2006	September 30, 2005
Salaries and employee benefits	$8,706	$8,534
Occupancy and furniture and fixtures	1,479	1,450
Data processing and ATM	922	1,172
Credit card processing	1,361	1,270
Intangibles and goodwill amortization	853	832
Net costs of other real estate owned	16	244
Other operating expenses	2,959	3,157

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

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

o Health insurance
o Employee life insurance
o Dental insurance
o Executive compensation plans (1)
o Qualified Pension plans (1)
o Supplemental retirement plan (salary continuation agreements)
o Employer FICA
o Unemployment taxes

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

Salaries and employee benefits expense was $8,706 at September 30, 2006, an increase of $172 or 2.0% when compared with the same period in 2005. Included in the increase is an $180 expense associated with a supplemental retirement plan that provides for salary continuation agreements with selected officers of the Company and its affiliates. This expense was offset by income from bank owned life insurance on the plan participants. (See the discussion of "Other Income".) The Company employed 248 fulltime equivalent employees at September 30, 2006 and 272 at September 30, 2005.

Occupancy costs include such items as depreciation expense, maintenance of the properties, repairs and real estate taxes. At September 30, 2006, occupancy and furniture and fixture expense was $1,479, an increase of $29 or 2.0% over the end of the first nine months of last year. The increase was due to fluctuation in various accounts, none of which represent a material change.

Data processing and ATM expense decreased by $250 when compared to September 30, 2005. A decline in maintenance cost of approximately $64 and a decrease in conversion expenses of $152 account for most of the decrease. Check imaging equipment to be installed in the fourth quarter of 2006 is expected to add approximately $8 per month to expense.

Credit card processing includes costs associated with the processing of credit cards, debit cards and merchant transactions. These expenses are related to credit card income previously discussed in "Noninterest Income", and the comments in that section are applicable. Credit card processing expense was $1,361 for the nine months ended September 30, 2006, an increase of $91 from the same period in 2005. Volume accounted for the increase.

Intangible expense is influenced by acquisitions, amortization schedules and impairment testing depending on the nature of the intangible. Core deposit intangibles are amortized while goodwill is subject to testing for impairment. Both generally increase with acquisitions. Intangibles amortization expense at September 30, 2006 was $853, an increase of $21 over the same period the previous year. The increase was associated with the acquisition of two branches in February 2005.

Net cost of other real estate owned consists of losses on disposal, repairs, write-downs and other foreclosure costs. Net costs of other real estate owned were down $228 when compared to the first nine months of last year. This category can fluctuate substantially depending on the number of properties on hand, the gains or losses on sale and the amount of write-downs.

Other operating expenses include all other forms of expense not classified elsewhere in the Company's statement of income. Included in this category are such items as stationery and supplies, franchise taxes, contributions, telephone, postage and other operating costs. Other operating expenses for the first nine months of 2006, at $2,959, were down $198 from the same period in the prior year, largely due to cost containment measures.

Balance Sheet

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

Assets	September 30, 2006	December 31, 2005
Interest-bearing deposits	10,490	14,819
Securities available for sale	163,997	151,431

Securities held to maturity	106,527	110,312
Mortgage loans held for sale	488	609
Real estate construction loans	27,178	26,926
Real estate mortgage loans	120,393	117,855
Commercial and industrial loans	240,035	200,799
Loans to individuals	104,223	148,088
Total Assets	$ 835,494	$ 819,341
Liabilities and stockholders equity		
Noninterest-bearing demand deposits	$ 110,329	$114,186
Interest-bearing demand deposits	222,523	204,522
Savings deposits	52,948	57,836
Time deposits	350,711	347,471
Other borrowings	562	705
Shareholders' equity	$94,499	$90,470

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Securities

During the third quarter of 2006 the Company sold approximately $823 in securities held to maturity. These securities consisted of 46 mortgage-backed securities that paid down over time. The sales were consistent with accounting rules that permit such sales.

Loans

Total loans net of unearned income at September 30, 2006 were $497,605, an increase of $4,994 or approximately 1.0% from December 31, 2005. This equates to an annualized growth rate of approximately 1.4%.

Deposits

Total deposits at September 30, 2006 decreased by $2,856 from December 31, 2005. Noninterest-bearing demand deposits decreased by $4,474 when September 30, 2006 is compared to December 31, 2005. During the same period, interest-bearing demand deposits decreased by $15,589, and time deposits increased by $22,463. Saving deposits during the period declined by $5,256.

Liquidity and Capital Resources

Net cash provided by operating activities was $11,143 for the period ended September 30, 2006, which compares to $11,497 for the same period the previous year.

Net cash used in investing activities was $10,133 for the period ended September 30, 2006, and $8,547 for the period ended September 30, 2005. Net cash used by financing activities was $6,527 for the period ending September 30, 2006.

Management is unaware of any commitment that would have a material and adverse effect on liquidity at September 30, 2006.

Total shareholders' equity grew by $5,864 from December 31, 2005 to September 30, 2006. Earnings, the changes in unrealized gains and losses for securities available for sale and a dividend of $2,524 accounted for the net increase. During the first nine months of 2006, the Company repurchased 42,100 shares of its own stock for approximately $987. See Part II Item 2 of this report for further information regarding stock repurchases. The Tier I and Tier II risk-based capital ratios at September 30, 2006 were 14.1% and 15.0%, respectively. The Company's leverage capital ratio was 10.2%

Interest Rate Sensitivity

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

	September 30, 2006				
Assets	1Year	2Year	3Year	4Year	5Year
Interest-bearing deposits	19,778	---	---	---	---
Securities available for sale	25,259	30,681	24,433	16,718	12,352
Securities held to maturity	12,788	6,624	11,876	20,456	15,602
Mortgage loans held for sale	223	---	---	---	---
Loans, net of unearned income	158,487	93,914	92,804	46,718	43,193
Total interest earning assets	216,535	131,219	129,113	83,892	71,147
Cumulative	216,535	347,754	476,867	560,759	631,906

Liabilities					
Interest-bearing demand deposits	210,022	---	---	---	---
Savings deposits	49,249	---	---	---	---
Time deposits	252,216	47,039	26,249	32,023	17,270
Other borrowings	76	---	---	---	---
Total interest bearing liabilities	511,563	47,039	26,249	32,023	17,270
Cumulative	511,563	558,602	584,851	616,874	634,144
Gap	(295,028)	84,180	102,864	51,869	53,877
Cumulative gap ratio	0.42	0.62	0.82	0.91	1.00

As shown in the above table, the Company is liability sensitive. In other words, the Company's interest-bearing liabilities reprice and/or mature at a faster rate than its interest-earning assets. During periods of rising interest rates, such as we have recently experienced, this causes the Company's net interest margin to decrease. This in turn has a negative impact on overall profitability.

Management's Discussion and Analysis of the Financial Condition and Results of Operations for the Three Months ended September 30, 2006

Net income for the three months ended September 30, 2006 was $3,201, up $147 when compared to the same period the prior year. Basic earnings per share for the second quarter of 2006 were $0.46 compared to $.44 in the third quarter of 2005.

Earnings

Interest rates have been steadily rising throughout 2005 and 2006. Because the Company is liability sensitive, the rising rates have had an adverse impact on net interest income. As shown in the statement of profit and loss, interest income increased by $559, while interest expense during the same period increased by $875. This produced a decline in net interest income of $316, when the third quarter of 2006 and 2005 are compared.

The provision for loan losses was $16 in the third quarter of 2006, a decrease from the $169 in the third quarter of 2005. Asset quality remains excellent. Therefore, based upon current information, the Company does not anticipate substantial additions to the allowance for loan losses.

Noninterest income increased by $340 when the third quarter of 2006 and 2005 are compared. With the exception of realized gains and losses on securities, which declined by $340, all other categories improved. Comments made in the year-to-date discussion apply. Other income was up significantly because of income from bank-owned life insurance contracts.

Noninterest expense was $5,396 for the quarter ended September 30, 2006. This represents an increase of $17 from the same period last year. Comments made in the year-to-date discussion apply. Data processing expense declined when compared to 2005 because of acquisition-related computer conversion costs in 2005. The cost of other real estate owned has dropped substantially as foreclosed properties have been liquidated.

In summary, the Company has experienced a decline in net interest income due to rising interest rates. To date, increases in the noninterest income areas, coupled with decreases in noninterest expense, have more than offset the decline in net interest income. The extent to which noninterest income and expense will continue to offset the decline in interest income is not currently known. If interest rates rise and the interest margin erodes further, it would

not be unreasonable to expect that net income could be negatively impacted. However, if interest rates remain stable, the Company's interest income could improve.

Derivatives and Off Balance Sheet Items

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

The Company's banking affiliate extends lines of credit to its customers in the normal course of business. Amounts drawn upon these lines vary at any given time depending on the business needs of the customers.

Standby letters of credit are also issued to the bank customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation.

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

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

Through three quarters of 2006, there have been no significant or unusual changes in these types of off balance sheet contractual obligations.

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, 2005. (See "Interest Rate Sensitivity".)

Item 4. Controls and Procedures

Under the supervision and with the participation of management, including the Company's principal executive officer and principal financial officer, the Company has conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures as of September 30, 2006. Based on that evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures are effective to give reasonable assurance in alerting them in a timely fashion to material information relating to the Company that is required to be included in the reports the Company files under the Act. There were no changes in the Company's internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Disclosure controls and procedures are the Company's controls and procedures that are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to allow timely decisions regarding its required disclosure. The Company believes that a controls system, no matter how well designed and operated, cannot provide absolute assurance that all control issues have been detected.

Part II
Other Information

Item 1. Legal Proceedings

There were no material legal proceedings for the quarter ending September 30, 2006.

Item 1A. Risk Factors

No material changes from risk factors as previously disclosed in the Company's 2005 Annual Report on Form 10-K.

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

The following table provides information about our purchases during the third quarter of 2006 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act.

Fiscal Period	Total Number of Shares Purchased	Average Price Paid per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)	Approximat Shares Th Be Purch the P Progr
July 1-31	3,900	$22.90	3,900	
August 1-31	4,500	$22.82	4,500	
September 1-30	3,000	$22.95	3,000	

1) Average price per share includes commissions.
2) On May 9, 2006 the Board approved repurchase of up to 100,000 shares of common stock in the period from June 1, 2006 through May 31, 2007.

Item 3. Defaults upon Senior Securities

None for the three months ended September 30, 2006.

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

None

Item 5. Other Information

None

Item 6. Exhibits

See Index of Exhibits.

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Signatures

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

DATE: November 8, 2006

NATIONAL BANKSHARES, INC.

/s/ JAMES G. RAKES

James G. Rakes
Chief Executive Officer

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Chief Financial Officer

(1) Index of Exhibits

Exhibit No.	Description	Page No. in Sequential System
3(i)	Articles of Incorporation, as amended, of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3(a) the Annual Report on Form 10-K for fiscal year ended December 31, 1993)
3(i)	Articles of Amendment to Articles of Incorporation of National Bankshares, Inc., dated April 8, 2003.	(incorporated herein by reference to exhibit 3(i) the Annual Report on Form 10-K for the fiscal yea ended December 31, 200
3(i)	Amended and Restated Articles of Incorporation of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3.1 o Form 8-K filed on March 16 2006)
4(i)	Specimen copy of certificate for National Bankshares, Inc. common stock.	(incorporated herein by reference to Exhibit 4(a) the Annual Report on Form 10-K for fiscal year ended December 31, 1993)
4(i)	Article Four of the Articles of Incorporation of National Bankshares, Inc. included in Exhibit No. of 3(a)	(incorporated herein by reference to Exhibit 4(b) the Annual Report on Form 10-K for fiscal year ended December 31, 1993)
10(ii)(B)	Computer software license agreement dated June 18, 1990, by and between Information Technology, Inc. and The National Bank of Blacksburg	(incorporated herein by reference to Exhibit 10(e) the Annual Report on Form 10-K for fiscal year ended December 31, 1992)

*10(iii)(A)	National Bankshares, Inc. 1999 Stock Option Plan	(incorporated herein by reference to Exhibit 4.3 o the Form S-8, filed as Registration No. 333-79979 with the Commission on Jun 1999)
*10(iii)(A)	Employment Agreement dated January 2002 between National Bankshares, Inc. and James G. Rakes	(incorporated herein by reference to Exhibit 10(ii of Form 10-Q for the perio ended June 30, 2002)

*10(iii)(A)	Employment Lease Agreement dated August 14, 2002 between National Bankshares, Inc., The National Bank of Blacksburg and James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of Form 10-Q fo the period ended June 30,
*10(iii)(A)	Change in Control Agreement dated January 5, 2003, between National Bankshares, Inc. and Marilyn B. Buhyoff	(incorporated herein by reference to Exhibit 10 ii of Form 10-K for the period ended December 31,
*10(iii)(A)	Change in Control Agreement dated January 8, 2003, between National Bankshares, Inc. and F. Brad Denardo	(incorporated herein by reference to Exhibit 10 ii of Form 10-K for the period ended December 31,
*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 Form 8-K fil 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 Form 8-K fil on February 8, 2006)
*10(iii)(A)	Salary Continuation Agreement dated February 8, 2006, between Bank of Tazewell County and J. Robert Buchanan.	(incorporated herein by reference to Exhibit 10(iii)(A) of Form 8-K fil on February 8, 2006)
*10(iii)(A)	Salary Continuation Agreement dated February 8, 2006, between Bank of Tazewell County and Marilyn B. Buhyoff.	(incorporated herein by reference to Exhibit 10(iii)(A) of Form 8-K fil on February 8, 2006)
31(i)	Section 302 Certification of Chief Executive Officer	Page 34
31(ii)	Section 302 Certification of Chief Financial Officer	Page 35
32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	Page 36
32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	Page 36

* Indicates a management contract or compensatory plan required to be filed herein.

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Exhibit No. 31(i)

CERTIFICATIONS UNDER SECTION 906 OF THE SARBANES OXLEY ACT OF 2002

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

1. I have reviewed this 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 evaluations; and

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

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

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

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

Date: November 8, 2006

/s/ JAMES G. RAKES

James G. Rakes

Chairman
President and Chief Executive Officer
(Principal Executive Officer)

Exhibit 31(ii)

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

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; and

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

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

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

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

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

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

Date: November 8, 2006

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Treasurer
(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 September 30, 2006, I, James G. Rakes, President and Chief Executive Officer of National Bankshares, Inc. (Principal Executive Officer), 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 September 30, 2006, 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 September 30, 2006, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ JAMES G. RAKES

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

Exhibit 32 (ii)

CERTIFICATION OF CHIEF 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 September 30, 2006, I, J. Robert Buchanan, Treasurer (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 September 30, 2006, 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 September 30, 2006, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan
Treasurer
(Principal Financial Officer)