

Edgar Filing: NATIONAL BANKSHARES INC - Form 10-K

NATIONAL BANKSHARES INC  
Form 10-K  
March 14, 2007

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

Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of  
the Securities Exchange Act of 1934  
For the Fiscal Year Ended December 31, 2006

OR

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

Commission File Number: 0-15204

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

Virginia  
(State of Incorporation)

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

101 Hubbard Street  
Blacksburg, Virginia, 24060  
(Address of principal executive offices) (Zip Code)

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

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

Securities registered Pursuant to Section 12(g) of the Act:  
Common Stock, Par Value \$1.25 per share

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

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

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in

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Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governanace) on June 30, 2006 (the last business day of the most recently completed second fiscal quarter) was approximately \$146,278,729. As of February 15, 2007, the registrant had 6,978,734 shares of voting common stock outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

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

| Document  | Part of Form 10-K<br>into which<br>incorporated |
|---|---|
| National Bankshares, Inc. 2006 Annual Report to Stockholders                          | Part II   |
| National Bankshares, Inc. Proxy Statement for the 2007 Annual Meeting of Stockholders | Part III  |

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### Part I

\$ In thousands, except per share data.

#### Item 1. Business

##### History and Business

National Bankshares, Inc. (the Company or NBI) is a financial holding company that was organized in 1986 under the laws of Virginia and is registered under the Bank Holding Company Act of 1956. It conducts most of its operations through its wholly-owned community bank subsidiary, the National Bank of Blacksburg (NBB). It also owns National Bankshares Financial Services, Inc. (NBFS), which does business as National Bankshares Insurance Services and National Bankshares Investment Services.

##### The National Bank of Blacksburg

The National Bank of Blacksburg, which does business as National Bank, was originally chartered in 1891 as the Bank of Blacksburg. Its state charter was converted to a national charter in 1922 and it became the National Bank of Blacksburg. In 2004, NBB purchased Community National Bank of Pulaski, Virginia. In May, 2006, Bank of Tazewell County, a Virginia bank which since 1996 had also been a wholly-owned subsidiary of NBI, was merged with and into NBB.

NBB is community-oriented, and it offers a full range of retail and commercial banking services to individuals, businesses, non-profits and local government units from its headquarters in Blacksburg, Virginia and its twenty-five branch offices throughout southwest Virginia. NBB has telephone and Internet banking and it operates twenty-five automated teller machines in its service area. Lending is focused at small and mid-sized businesses and at individuals. Loan types include commercial, agricultural, real estate, home equity and consumer. Merchant credit card services and business and consumer credit cards are available. Deposit accounts offered include demand deposit accounts, money market deposit accounts, savings accounts and certificates of deposit. NBB offers other miscellaneous services normally provided by commercial banks, such as letters of credit, night depository, safe deposit boxes, travelers checks, utility payment services and automatic funds transfer. NBB conducts a general trust business that has wealth management and trust and estate services for individual and business customers.

At December 31, 2006, NBB had total assets of \$864,107 and total deposits of \$764,815. NBB's net income for 2006 was \$12,876, which produced a return on average assets of 1.54% and a return on average equity of 14.33%. Refer to Note 12 of the Notes to Consolidated Financial Statements for NBB's risk-based capital ratios.

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National Bankshares Financial Services, Inc.

In 2001, National Bankshares Financial Services, Inc, was formed in Virginia as a wholly-owned subsidiary of NBI. NBFS offers non-deposit investment products and insurance products for sale to the public. NBFS works cooperatively with Bankers Investments, LLC to provide investments and with Bankers Insurance, LLC for insurance products. NBFS does not significantly contribute to NBI's net income.

### Operating Revenue

The percentage of total operating revenue attributable to each class of similar service that contributed 15% or more of the Company's total operating revenue for the years ended December 31, 2006, 2005 and 2004 is set out in the following table.

| Period            | Class of Service           | Percentage of Total Revenues |
|-------------------|----------------------------|------------------------------|
| -----             | -----                      | -----                        |
| December 31, 2006 | Interest and Fees on Loans | 61.51%                       |
|                   | Interest on Investments    | 21.76%                       |
| December 31, 2005 | Interest and Fees on Loans | 62.71%                       |
|                   | Interest on Investments    | 21.96%                       |
| December 31, 2004 | Interest and Fees on Loans | 61.30%                       |
|                   | Interest on Investments    | 23.60%                       |

### Market Area

NBB's market area in southwest Virginia is made up of the counties of Montgomery, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It also includes the cities of Radford and Galax, and the portions of Carroll and Grayson County that are adjacent to Galax. The bank also serves those portions of Mercer County and McDowell County, West Virginia that are contiguous with Tazewell County, Virginia. Although largely rural, the market area is home to two major universities, Virginia Tech and Radford University, and to three community colleges. Virginia Tech, located in Blacksburg, Virginia, is the area's largest employer and is the Commonwealth's largest university. A second state supported university, Radford University, is located nearby. Employment at the universities has been stable and is expected to remain so. In recent years Virginia Tech's Corporate Research Center has brought several high-tech companies to Montgomery County.

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In addition to education, the market area has a diverse economic base, with manufacturing, agriculture, tourism, healthcare, retail and service industries all represented. Large manufacturing facilities in the region include Celanese Acetate, the largest employer in Giles County, and Volvo Heavy Trucks, the largest company in Pulaski County. Both of these firms have experienced layoffs within the past three years. Pulaski and Galax have been centers for furniture manufacturing. In recent years, this industry has been declining because of growing furniture imports. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that has been improving over the past few years. Both Montgomery County and Bluefield in Tazewell County are regional retail centers and have facilities to provide basic health care for the region.

NBB's market area offers the advantages of a good quality of life, scenic beauty, moderate climate and historical and cultural attractions. The region has some recent success attracting retirees, particularly from the Northeast and urban northern Virginia.

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### Competition

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

### Organization and Employment

NBI, NBB and NBFS are organized in a holding company/subsidiary structure. Functions that serve multiple subsidiaries, including audit, compliance, loan review and human resources, are at the holding company level. Until May, 2006, when it was merged with and into NBB, NBI operated a second wholly-owned bank subsidiary, Bank of Tazewell County.

At December 31, 2006, NBI employed 15 full time employees, NBB had 229.5 full time equivalent employees and NBFS had 4 full time employees.

### Regulation, Supervision and Government Policy

NBI and NBB are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like NBI and NBB are at a disadvantage to other competitors who are not as highly regulated, and their costs of doing business are higher. A brief summary follows of certain laws, rules and regulations which affect NBI and NBB. Any changes in the laws and regulations governing banking and financial services could have an adverse effect on the business prospects of NBI and NBB.

### National Bankshares, Inc.

NBI is a bank holding company under the Federal Bank Holding Company Act (BHCA), which is administered by the Board of Governors of the Federal Reserve System (the Federal Reserve). NBI is required to file an annual report with the Federal Reserve and may be required to furnish additional information pursuant to the BHCA. The Federal Reserve is authorized to examine NBI and its subsidiaries. With some limited exceptions, the BHCA requires a bank holding company to obtain prior approval from the Federal Reserve before acquiring or merging with a bank or before acquiring more than 5% of the voting shares of a bank unless it already controls a majority of shares.

The Bank Holding Company Act. Under the BHCA, a bank holding company is generally prohibited from engaging in nonbanking activities unless the Federal Reserve has found those activities to be incidental to banking. Bank holding companies also may not acquire more than 5% of the voting shares of any company engaged in nonbanking activities. Amendments to the BHCA that were included in the Gramm-Leach-Bliley Act of 1999 (see below) permitted any bank holding company with bank subsidiaries that are well-capitalized, well-managed and which have a satisfactory or better rating under the Community Reinvestment Act (see below) to file an election with the Federal Reserve to become a financial holding company. A financial holding company may engage in any activity that is

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(i) financial in nature (ii) incidental to a financial activity or (iii) complementary to a financial activity. Financial activities include insurance underwriting, securities dealing and underwriting and providing financial, investment or economic advising services. NBI is a financial holding company.

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The Virginia Banking Act. The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission (the Commission). NBI is required to report to the Commission with respect to financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act (GLBA) permits significant combinations among different sectors of the financial services industry, allows for expansion of financial service activities by bank holding companies and offers financial privacy protections to consumers. GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. GLBA permits affiliations between banks and securities firms in the same holding company structure, and it permits financial holding companies to directly engage in a broad range of securities and merchant banking activities.

The Sarbanes-Oxley Act. The Sarbanes-Oxley Act (SOX) enacted sweeping reforms of the federal securities laws intended to protect investors by improving the accuracy and reliability of corporate disclosures. It impacts all companies with securities registered under the Securities Exchange Act of 1934, including NBI. SOX creates increased responsibility for chief executive officers and chief financial officers with respect to the content of filings with the Securities and Exchange Commission. Section 404 of SOX and related Securities and Exchange Commission rules focused increased scrutiny by internal and external auditors on NBI's systems of internal controls over financial reporting, which is designed to insure that those internal controls are effective in both design and operation. SOX sets out enhanced requirements for audit committees, including independence and expertise, and it includes stronger requirements for auditor independence and limits the types of non-audit services that auditors can provide. Finally, SOX contains new and increased civil and criminal penalties for violations of securities laws.

Capital Requirements. The Federal Reserve has adopted risk-based capital guidelines that are applicable to NBI. The guidelines provide that the Company must maintain a minimum ratio of 8% of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit). At least half of total capital must be comprised of Tier 1 capital, for a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition, the Federal Reserve has established minimum leverage ratio guidelines of 4% for banks that meet certain specified criteria. The leverage ratio is the ratio of Tier 1 capital to total average assets, less intangibles. NBI is expected to be a source of capital strength for its subsidiary bank, and regulators can undertake a number of enforcement actions against NBI if its subsidiary bank becomes undercapitalized. NBI's bank subsidiary is well capitalized and fully in compliance with capital guidelines.

Bank regulators could choose to raise capital requirements for banking organizations beyond current levels. NBI is unable to predict if higher capital levels may be mandated in the future.

The National Bank of Blacksburg

NBB is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency (OCC). NBB's deposits are insured by

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the Federal Deposit Insurance Corporation (FDIC) up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of NBB's operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. NBB is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs. OCC requires NBB to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for NBB and other banks.

The Community Reinvestment Act. NBB is subject to the provisions of the Community Reinvestment Act (CRA), which imposes an affirmative obligation on financial institutions to meet the credit needs of the communities they serve, including low- and moderate-income neighborhoods. The OCC monitors NBB's compliance with the CRA and assigns public ratings based upon the bank's performance in meeting stated assessment goals. Unsatisfactory CRA ratings can result in restrictions on bank operations or expansion. NBB received a "satisfactory" rating in its last CRA examination by the OCC.

The Gramm-Leach-Bliley Act. In addition to other consumer privacy provisions, the Gramm-Leach-Bliley Act (GLBA) restricts the use by financial institutions of customers' nonpublic personal information. At the inception of the customer relationship and annually thereafter, NBB is required to provide its customers with information regarding its policies and procedures with respect to handling of customers' nonpublic personal information. GLBA generally prohibits a financial institution from providing a customer's nonpublic personal information to unaffiliated third parties without prior notice and approval by the customer.

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The USA Patriot Act. The USA Patriot Act (Patriot Act) facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on NBB to establish and maintain anti-money laundering policies and procedures, including a customer identification program. The bank is also required to screen all customers against government lists of known or suspected terrorists. There is additional regulatory oversight to insure compliance with the Patriot Act.

Consumer Laws and Regulations. There are a number of laws and regulations that regulate banks' consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Expedited Funds Availability Act and the Fair Debt Collections Practices Act. NBB is required to comply with these laws and regulations in its dealings with customers. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations.

Deposit Insurance. NBB has deposits that are insured by the Federal Deposit Insurance Corporation (FDIC). FDIC maintains a Bank Insurance Fund (BIF) that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the BIF declines in relation to the total amount of insured deposits. In 2006, NBB was required to pay the minimum BIF assessment. FDIC has announced that assessments will increase for 2007, because insured deposits have

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grown at a faster rate than the BIF balance. However, many banks, including NBB, will have certain payment credits that will offset these 2007 assessment increases.

After giving primary regulators an opportunity to first take action, FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution's deposit insurance. NBB has no knowledge of any matter that would threaten its FDIC insurance coverage.

**Capital Requirements.** The same capital requirements that are discussed above with relation to on NBI are applied to NBB by OCC. The OCC guidelines provide that banks experiencing internal growth or making acquisitions are expected to maintain strong capital positions well above minimum levels, without reliance on intangible assets.

**Limits on Dividend Payments.** A significant portion of NBI's income is derived from dividends paid by NBB. As a national bank, NBB may not pay dividends from its capital, and it may not pay dividends if the bank would be undercapitalized, as defined by regulation, after paying the dividend. Without prior OCC approval, NBB's dividend payments in any calendar year are restricted to the bank's retained net income for that year, as that term is defined by the laws and regulations, combined with retained net income from the preceding two years, less any required transfer to surplus.

The OCC and FDIC have authority to limit dividends paid by NBB if the payment were determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the bank's capital base could be deemed to be an unsafe and unsound banking practice.

**Branching.** As a national bank, NBB is required to comply with the state branch banking laws of Virginia, the state in which the bank is located. NBB must also have the prior approval of OCC to establish a branch or acquire an existing banking operation. Under Virginia law, NBB may open branch offices or acquire existing banks or bank branches anywhere in the state. Virginia law also permits banks domiciled in the state to establish a branch or to acquire an existing bank or branch in another state.

### Monetary Policy

The monetary and interest rate policies of the Federal Reserve, as well as general economic conditions, affect the business and earnings of NBI. NBB and other banks are particularly sensitive to interest rate fluctuations. The spread between the interest paid on deposits and that which is charged on loans is the most important component of the bank's profits. In addition, interest earned on investments held by NBI and NBB has a significant effect on earnings. As conditions change in the national and international economy and in the money markets, the Federal Reserve's actions, particularly with regard to interest rates, can impact loan demand, deposit levels and earnings at NBB. It is not possible to accurately predict the effects on NBI of economic and interest rate changes.

### Other Legislative and Regulatory Concerns

Federal and state laws and regulations are regularly proposed that could affect the regulation of financial institutions. New regulations could add to the regulatory burden on banks and increase the costs of compliance, or they could change the products that can be offered and the manner in which banks do business. We cannot foresee how regulation of financial institutions may change in the future and how those changes might affect NBI.



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### Company Website

NBI maintains a website at [www.nationalbankshares.com](http://www.nationalbankshares.com). The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission.

### Item 1A. Risk Factors

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

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

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

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

If there is little economic growth in our market area, loan demand could suffer.

There are some portions of our market area with slow economic growth and limited loan demand. If the number and size of these areas increase, loan demand could suffer. Since loans are the Company's most profitable investment, this could lead to lower earnings.

If the State of Virginia alters its philosophy with regard to providing on-campus housing for students at state-supported universities, the Company's loan portfolio could be negatively affected.

A number of the Company's large commercial real estate loans are secured with property used for off-campus student housing at two state universities. If the State of Virginia determines that it will provide on-campus housing for all students, the ability of customers to repay their loans could be adversely affected, which could in turn impact the Company.

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

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

### Item 1B. Unresolved Staff Comments

There are none.

### Item 2. Properties

NBB owns and has a branch bank in NBI's headquarters building located at 101 Hubbard Street, Blacksburg, Virginia. The bank's main office is at 100 South Main Street, Blacksburg, Virginia. NBB owns an additional twenty branch offices and it leases four. NBB also owns an unused branch building that is being offered for sale. NBI owns a building in Pulaski, Virginia that is rented. We believe that existing facilities are adequate for current needs and to meet anticipated growth.

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### Item 3. Legal Proceedings

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

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

No matters were submitted to a vote of security holders during the fourth quarter ended December 31, 2006.

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## Part II

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

#### Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the NASDAQ Capital Market under the symbol "NKSH". As of December 31, 2006, there were 930 record stockholders of NBI common stock. The following is a summary of the market price per share and cash dividend per share of the common stock of National Bankshares, Inc. for 2006 and 2005, adjusted for the effects of a March 31, 2006 2-for-1 stock split.

#### Common Stock Market Prices

|                | 2006     |       | 2005     |       |   |
|----------------|----------|-------|----------|-------|---|
|                | High     | Low   | High     | Low   |   |
| First Quarter  | \$ 25.15 | 23.01 | \$ 26.53 | 22.58 | 2 |
| Second Quarter | 24.99    | 21.90 | 24.38    | 21.88 | 0 |
| Third Quarter  | 23.24    | 22.01 | 23.73    | 22.28 |   |
| Fourth Quarter | 24.64    | 22.30 | 23.63    | 22.62 | 0 |

NBI's primary source of funds for dividend payments is dividends from its bank subsidiary, NBB. Bank dividend payments are restricted by regulators, as more fully disclosed in Note 11 of Notes to Consolidated Financial Statements.

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

Total Number of  
Shares Purchased

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| Fiscal Period | Total Number<br>of Shares Purchased | Average Price<br>Paid per Share(1) | as Part of Publicly Announced<br>Plans or Programs(2) |
|---------------|-------------------------------------|------------------------------------|---|
| October       | 4,800                               | \$ 23.20                           | 4,800   |
| November      | 600                                 | \$ 24.46                           | 600   |
| December      | 1,350                               | \$ 24.48                           | 1,350   |

1) Average price per share includes commissions.

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

### Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Index and a peer group index comprised of southeastern independent community banks and bank holding companies for the five-year period commencing on December 31, 2006. These comparisons assume the investment of \$100 in National Bankshares, Inc. common stock and in each of the indices on December 31, 2001, and the reinvestment of dividends.

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[GRAPHIC OMITTED][Five Year Performance Index Graph]

|                           | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------------------|------|------|------|------|------|
| NATIONAL BANKSHARES, INC. | 100  | 149  | 246  | 275  | 248  |
| INDEPENDENT BANK INDEX    | 100  | 124  | 168  | 193  | 199  |
| NASDAQ INDEX              | 100  | 69   | 103  | 113  | 115  |

The peer group Independent Bank Index is the compilation of the total return to stockholders over the past five years of the following group of 28 independent community banks located in the southeastern states of Alabama, Florida, Georgia, North Carolina, Tennessee, Virginia and West Virginia: Auburn National Bancshares, Inc., United Security Bancshares, Inc., TIB Financial Corp., Seacoast Banking Corp., Centerstate Banks of Florida, Inc., Fidelity Southern Corp., Southeastern Banking Corporation, Southwest Georgia Financial Corp., PAB Bankshares, Inc., Uwharrie Capital Corp., Four Oaks Fincorp, Inc., Bank of Granite Corp., Carolina Trust Bank, FNB Financial Services Corp., BNC Bancorp, CNB Corporation, Peoples Bancorporation, Inc., Greer Bancshares Incorporated, Wilson Bank Holding Company, First Pulaski National Corporation, National Bankshares, Inc., Monarch Financial Holdings, Inc., FNB Corporation, American National Bankshares, Inc., Central Virginia Bankshares, Inc., Virginia Financial Group, C&F Financial Corporation and First Century Bankshares, Inc.

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Item 6. Selected Financial Data

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

|             |                           | Years ended December 31 |           |           |
|-------------|---------------------------|-------------------------|-----------|-----------|
|             |                           | 2006                    | 2005      | 2004      |
| Selected    | Interest income           | \$ 47,901               | \$ 45,380 | \$ 41,492 |
| Income      | Interest expense          | 18,564                  | 14,180    | 11,125    |
| Statement   | Net interest income       | 29,337                  | 31,200    | 30,367    |
| Data:       | Provision for loan losses | 49                      | 567       | 1,189     |
|             | Noninterest income        | 8,802                   | 7,613     | 7,142     |
|             | Noninterest expense       | 21,670                  | 21,898    | 20,336    |
|             | Income taxes              | 3,788                   | 3,924     | 3,754     |
|             | Net income                | 12,632                  | 12,424    | 12,230    |
| Per Share   | Basic net income          | 1.80                    | 1.77      | 1.74      |
| Data:       | Diluted net income        | 1.80                    | 1.76      | 1.73      |
|             | Cash dividends declared   | 0.73                    | 0.71      | 0.64      |
|             | Book value per share      | 13.86                   | 13.10     | 12.38     |
| Selected    | Loans, net                | 495,486                 | 487,162   | 472,199   |
| Balance     | Total securities          | 285,489                 | 272,541   | 250,708   |
| Sheet Data  | Total assets              | 868,203                 | 841,498   | 796,154   |
| at End of   | Total deposits            | 764,692                 | 745,649   | 705,932   |
| Year:       | Stockholders' equity      | 96,755                  | 91,939    | 87,088    |
| Selected    | Loans, net                | 488,624                 | 487,130   | 438,761   |
| Balance     | Total securities          | 271,066                 | 261,743   | 250,305   |
| Sheet Daily | Total assets              | 840,080                 | 819,341   | 753,730   |
| Averages:   | Total deposits            | 741,071                 | 724,015   | 665,627   |
|             | Stockholders' equity      | 94,194                  | 90,470    | 84,479    |
| Selected    | Return on average assets  | 1.50%                   | 1.52%     | 1.62%     |
| Ratios:     | Return on average equity  | 13.41%                  | 13.73%    | 14.48%    |
|             | Dividend payout ratio     | 40.44%                  | 40.17%    | 36.83%    |

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|                   |        |        |        |
|-------------------|--------|--------|--------|
| -----             |        |        |        |
| Average equity to |        |        |        |
| -----             |        |        |        |
| average assets    | 11.21% | 11.04% | 11.21% |
| -----             |        |        |        |

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

The following discussion and analysis provides information about the results of operations, financial condition, liquidity and capital resources of National Bankshares, Inc. and its subsidiaries. The discussion should be read in conjunction with the material presented in Item 8, "Financial Statements and Supplementary Data", of this Form 10-K.

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

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

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

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

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unallocated allowance captures losses that are attributable to various economic events and to industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized either in the formula or in the specific allowance.

### Core deposit intangibles

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

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

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### Overview

National Bankshares, Inc. 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 and National Bankshares Financial Services, Inc. The National Bank of Blacksburg, which does business as National Bank from twenty-six office locations, is a community bank. NBB is the source of nearly all of the Company's revenue. National Bankshares Financial Services, Inc. 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.

On May 26, 2006, a second wholly-owned bank subsidiary, Bank of Tazewell County, was merged with and into the National Bank of Blacksburg. The merger allows bank customers to transact business at any of the bank's office locations throughout the region, and it permits the bank to realize certain economies of scale and efficiencies in its operations. The merger of the two bank subsidiaries also provided an opportunity to rejuvenate NBB's brand image with a new logo and to use it consistently throughout the market area.

### Performance Summary

The following table presents NBI's key performance ratios for the years ending December 31, 2006 and December 31, 2005:

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|                                      | 12/31/06 | 12/31/05 |
|--------------------------------------|----------|----------|
| Return on average assets             | 1.50%    | 1.52%    |
| Return on average equity             | 13.41%   | 13.73%   |
| Basic net earnings per share         | \$1.80   | \$1.77   |
| Fully diluted net earnings per share | \$1.80   | \$1.76   |
| Net interest margin (1)              | 4.13%    | 4.45%    |
| Noninterest margin (2)               | 1.54%    | 1.74%    |

(1) Net Interest Margin - Year-to-date tax equivalent net interest income divided by year-to-date average earning assets.

(2) Noninterest Margin - noninterest income (excluding securities gain and losses) less noninterest expense (excluding the provision for bad debts and income taxes) divided by average year-to-date assets.

Basic net earnings per share grew by \$0.03 per share because net earnings were higher than in 2005 and also because, as a result of the Company's stock repurchase program, the number of shares of stock outstanding was slightly lower. Although return on average assets and average equity declined slightly when compared with last year, they remained competitive when compared to peers. Return on average assets declined because the internally generated growth in total assets in 2006 increased at a faster rate than net earnings. Return on average equity was lower than in 2005 because the Company's equity, mostly from retained earnings, increased more rapidly than did the current year's net earnings. Reflecting the effects of 2006 Federal Reserve interest rate increases on NBI's funding costs, the net interest margin declined to 4.13% from 4.45% at the end of 2005. The noninterest margin declined by 20 basis points.

#### Growth

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

|              | For the period ending |           |
|--------------|-----------------------|-----------|
|              | 12/31/06              | 12/31/05  |
| Securities   | \$285,489             | \$272,541 |
| Loans, net   | 495,486               | 487,162   |
| Deposits     | 764,692               | 745,649   |
| Total assets | 868,203               | 841,498   |

Total assets at December 31, 2006 were \$868,203, an increase of \$26,705 or 3.2%. Loans net of unearned income and deferred fees increased \$8,032 or 1.6%. Total deposits at period-end were \$764,692, an increase of \$19,043 or 2.6%. For 2006, growth in each of the categories was internally generated, but in 2005 the increase of approximately \$8,831 in loans and approximately \$22,009 in deposits was related to the acquisition of two branch offices in the first quarter of the year.

## Asset Quality

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

|                                    | 12/31/06 | 12/31/05 |
|------------------------------------|----------|----------|
| Nonperforming loans                | \$ ---   | \$ 178   |
| Loans past due over 90 days        | 681      | 546      |
| Other real estate owned            | 390      | 376      |
| Allowance for loan losses to loans | 1.03%    | 1.11%    |
| Net charge-off ratio               | .07%     | .17%     |

At December 31, 2006, several indicators of the Company's asset quality improved from the already good levels of December 31, 2005. There were no nonperforming loans, and there was a decline in the net charge-off ratio. These factors were key indicators that asset quality was good and trends continued to be satisfactory, therefore the Company determined that it was appropriate to allow the ratio of the allowance for loan losses to loans to decline slightly. The provision for loan losses was \$49 in 2006, and it was \$567 in 2005. The ratio of the allowance for loan losses to loans was 1.03% at December 31, 2006 and 1.11% at December 31, 2005.

## Net Interest Income

Net interest income for the period ended December 31, 2006 was \$29,337, a decrease of \$1,863 or 6.0%.

The rising interest rate environment in 2006, coupled with the Company's liability sensitive balance sheet, accounted for the decline in the net interest margin. The table "Analysis of Change in Interest Income and Expense" included in this report indicates that most of the change in net interest income was due to rising interest rates, offset somewhat by volume.

In 2005, net interest income totaled \$31,200, an increase of \$833 or 2.7% over 2004. This increase was due to a combination of factors. The "Analysis of Change in Interest Income and Expenses" shows that increased loan volume accounted for most of the increase in interest income. Also, rising interest rates had a negative affect on interest-bearing liabilities.

The Federal Reserve followed a policy of regular interest rate increases throughout all of 2005 and the first six months of 2006. In mid 2006, the Federal Reserve ceased imposing regular rate increases.

If the interest rate environment stabilizes in 2007 because the Federal Reserve continues to hold short-term interest rates steady, management anticipates that the Company's funding costs and net interest margin will stabilize as well. If this occurs, it will eventually have a positive impact on the level of net interest income. However, there are also risks to improving net interest income. The Federal Reserve has articulated a policy of balancing concern over the risk of inflation with concern over slowing economic growth. If inflationary pressures increase, the Federal Reserve may respond with another round of interest rate increases, which would have a negative effect on NBI's net interest income in the intermediate term. The Company's level of net interest income can also be impacted by overall economic conditions and by competition in its market area. Loan volume, one component of net interest income, could decline if there is a protracted slowdown in the real estate market, and loan volume is affected when there is increased competition from



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other financial service providers. Increased competition may also force the Company to pay a higher level of interest on deposits. This impacts the cost of funds, another component of net interest income.

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### Analysis of Net Interest Earnings

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

| (\$ in thousands)                                   | December 31, 2006 |                 |                    | December 31, 2005 |                 |                    |
|---|-------------------|-----------------|--------------------|-------------------|-----------------|--------------------|
|   | Average Balance   | Interest        | Average Yield/Rate | Average Balance   | Interest        | Average Yield/Rate |
| <b>Interest-earning assets:</b>                     |                   |                 |                    |                   |                 |                    |
| Loans, net (1) (2) (3)                              | \$ 494,495        | \$35,134        | 7.11%              | \$ 492,760        | \$33,400        | 6.78%              |
| Taxable securities                                  | 152,715           | 7,462           | 4.89%              | 135,347           | 6,501           | 4.80%              |
| Nontaxable securities (1) (4)                       | 119,931           | 7,502           | 6.25%              | 125,683           | 7,960           | 6.33%              |
| Federal funds sold                                  | ---               | ---             | ---                | ---               | ---             | ---                |
| Interest bearing deposits                           | 13,457            | 684             | 5.08%              | 14,819            | 508             | 3.43%              |
| <b>Total interest-earning assets</b>                | <b>\$ 780,598</b> | <b>\$50,782</b> | <b>6.51%</b>       | <b>\$ 768,609</b> | <b>\$48,369</b> | <b>6.29%</b>       |
| <b>Interest-bearing liabilities:</b>                |                   |                 |                    |                   |                 |                    |
| Interest-bearing demand deposits                    | \$221,927         | \$ 4,152        | 1.87%              | \$204,522         | \$ 2,675        | 1.31%              |
| Savings deposits                                    | 51,745            | 259             | 0.50%              | 57,836            | 261             | 0.45%              |
| Time deposits                                       | 358,422           | 14,127          | 3.94%              | 347,471           | 11,221          | 3.23%              |
| Short-term borrowings                               | 420               | 26              | 6.19%              | 705               | 23              | 3.26%              |
| <b>Total interest-bearing liabilities</b>           | <b>\$632,514</b>  | <b>\$18,564</b> | <b>2.94%</b>       | <b>\$610,534</b>  | <b>\$14,180</b> | <b>2.32%</b>       |
| <b>Net interest income and interest rate spread</b> |                   | <b>\$32,218</b> | <b>3.57%</b>       |                   | <b>\$34,189</b> | <b>3.97%</b>       |
| <b>Net yield on average interest-earning assets</b> |                   |                 | <b>4.13%</b>       |                   |                 | <b>4.45%</b>       |

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three years presented.

(2) Loan fees of \$798 in 2006, \$650 in 2005 and \$473 in 2004 are included

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in total interest income. (3) Nonaccrual loans are included in average balances for yield computations. (4) Daily averages are shown at amortized cost.

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### Analysis of Changes in Interest Income and Interest Expense

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

| (\$ in thousands)  | 2006 Over 2005 |            |                      |         |
|--|----------------|------------|----------------------|---------|
|  | Changes Due To |            | Net Dollar<br>Change | Rate    |
|  | Rates (2)      | Volume (2) |                      |         |
| Interest income:(1)  |                |            |                      |         |
| Loans  | \$ 1,616       | \$ 118     | \$ 1,734             | \$ 2    |
| Taxable securities   | \$ 115         | 847        | 962                  | (3)     |
| Nontaxable securities  | (97)           | (361)      | (459)                | (1)     |
| Federal funds sold   | ---            | ---        | ---                  | -       |
| Interest-bearing deposits                                      | 226            | (50)       | 176                  | 3       |
| <hr style="border-top: 1px dashed black;"/>                    |                |            |                      |         |
| Increase(decrease) in income on interest-earning asset         | \$ 1,859       | \$ 554     | \$ 2,413             | \$ 1    |
| <hr style="border-top: 1px dashed black;"/>                    |                |            |                      |         |
| Interest expense:  |                |            |                      |         |
| Interest-bearing demand deposits                               | \$ 1,233       | \$ 244     | \$ 1,477             | \$ 9    |
| Savings deposits   | 27             | (29)       | (2)                  | -       |
| Time deposits  | 2,543          | 363        | 2,906                | 1,3     |
| Short-term borrowings  | 15             | (12)       | 3                    | -       |
| <hr style="border-top: 1px dashed black;"/>                    |                |            |                      |         |
| Increase (decrease) in expense of interest-bearing liabilities | \$ 3,818       | \$ 566     | \$ 4,384             | \$ 2,2  |
| <hr style="border-top: 1px dashed black;"/>                    |                |            |                      |         |
| Increase (decrease) in net interest income                     | \$ (1,959)     | \$ (12)    | \$ (1,971)           | \$ (2,1 |
| <hr style="border-top: 3px double black;"/>                    |                |            |                      |         |

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2006, 2005 and 2004.

(2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

## Interest Rate Sensitivity

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Interest rate sensitivity analyses provides management with information related to repricing opportunities, while interest rate shock simulations indicate potential economic loss due to future interest rate changes. Risk factors and forward-looking statements previously discussed under "Net Interest Income" apply. As previously stated, the Company uses simulation analysis to forecast its balance sheet and monitor interest rate sensitivity. One test is a shock analysis that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on net income and return on average assets and return on average equity projected at December 31, 2006 and at December 31, 2005. For purposes of this analysis noninterest income and expenses are assumed to be flat.

(\$ in thousands, except for percent data)

| Rate Shift (bp) | Return on Average Assets |       | Return on Average Equity |        |
|-----------------|--------------------------|-------|--------------------------|--------|
|                 | 2006                     | 2005  | 2006                     | 2005   |
| 300             | 1.64%                    | 1.45% | 14.62%                   | 13.21% |
| 200             | 1.68%                    | 1.55% | 15.03%                   | 14.11% |
| 100             | 1.73%                    | 1.65% | 15.44%                   | 15.01% |
| (-)100          | 1.80%                    | 1.79% | 16.11%                   | 16.32% |
| (-)200          | 1.81%                    | 1.81% | 16.18%                   | 16.48% |
| (-)300          | 1.82%                    | 1.80% | 16.24%                   | 16.42% |

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

## Noninterest Income

|                                | December 31, 2006 | December 31, 2005 | December 31, 2004 |
|--------------------------------|-------------------|-------------------|-------------------|
| Service charges on deposits    | \$3,361           | \$3,099           | \$3,099           |
| Other service charges and fees | 370               | 347               | 347               |
| Credit card fees               | 2,396             | 2,179             | 1,962             |

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|                                  |         |         |       |
|----------------------------------|---------|---------|-------|
| Trust fees                       | 1,528   | 1,398   |       |
| Other income                     | 1,117   | 590     |       |
| Realized securities gains/losses | 30      | ---     |       |
|                                  | --      | ---     |       |
| Total noninterest income         | \$8,802 | \$7,613 | \$7,  |
|                                  | =====   | =====   | ===== |

Service charges on deposits for the year 2006 were \$3,361, an increase of \$262 or 8.5%. This compares with an increase of \$96 or 3.2% for the year 2005.

The increase in 2006 resulted from increases in fees for paid checking account overdrafts and fees collected for checks returned because of insufficient funds.

The modest increase in 2005 was the result of both internal growth and the acquisition of two branches. Approximately \$42 of the increase was attributable to acquisitions, with the balance of the increase due to internal growth.

Other service charges and fees at December 31, 2006 were \$370, an increase of \$23 or 6.6%. In 2005, this category experienced an increase of \$67 or 23.9%.

In 2006, a majority of the increase, or \$15, came from increases in fees associated with letters of credit. Safe deposit box rent and credit life insurance commissions accounted for an additional \$5 of the 2006 increase.

The \$67 increase in other service charges and fees in 2005 came about in part by a \$27 increase in check income and an increase of \$27 in service charges was the result of higher volume.

A variety of fees, such as fees for the issuance of official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and commission earned on the sale of credit life, accident and health insurance are included in this income category.

Credit card fees for 2006 increased by \$217, or 10%. In 2005, that category was up \$340, or 18.5%. Credit card transaction fees, debit card transaction fees and merchant fees are included in this category. Internal growth, resulting in a higher volume of accounts, transactions and merchant transactions, caused the increases in 2006 and 2005 credit card fee income.

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For the year ended December 31, 2006, trust fees were \$1,528, as compared with \$1,398 in 2005 and \$1,436 in 2004. Trust fees are generated from a number of different types of accounts, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income varies depending upon the types of accounts under management and with market conditions. Trust account values are affected by financial market conditions that lead to fluctuations in trust income. The increase in trust fees for 2006 is attributable to both factors, the mix of account types and positive financial market performance. The \$38 decline from 2004 to 2005 was the result of a decline of \$103 in income from estates and attorney-in-fact accounts, which was partially offset by an increase of \$65 in other categories of trust accounts.

Income that cannot be classified in another category is listed as other income. Net gains from the sales of fixed assets, rent from foreclosed properties, income from the increase in the cash value of life insurance and revenue from investment and insurance sales are examples of other income. The other income category at December 31, 2006 was \$1,117, an increase of \$527 or 89.3% when compared with 2005. Of the \$527 growth in other income in 2006, approximately \$504 was attributable to increases in cash value associated with bank-owned life insurance policies that were purchased late in 2005 to fund a salary continuation plan for certain NBI and NBB officers. Compared with 2004's other income total of \$416, 2005's other income of \$590 increased by \$174 or

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41.8%. Higher income from investment and insurance sales accounted for \$171 of the \$174 increase in other income in 2005.

For 2006, realized gains in securities matured or sold were \$30. This compares with no losses or gains in 2005 and \$168 in gains for 2004.

### Noninterest Expense

2005 vs 2004

|                                       | December 31, 2006 | December 31, 2005 |  |
|---------------------------------------|-------------------|-------------------|--|
| Salaries and employee benefits        | \$11,466          | \$11,265          |  |
| Occupancy and furniture and fixtures  | 1,957             | 1,931             |  |
| Data processing and ATM               | 1,234             | 1,455             |  |
| Credit card processing                | 1,833             | 1,687             |  |
| Intangibles and goodwill amortization | 1,137             | 1,117             |  |
| Net costs of other real estate owned  | 19                | 275               |  |
| Other operating expenses              | 4,024             | 4,168             |  |
|                                       | -----             | -----             |  |
|                                       | \$21,670          | \$21,898          |  |
|                                       | =====             | =====             |  |

From December 31, 2005 to December 31, 2006, salary and benefits expense increased by \$201, or 1.8%, to \$11,466. This compares with the \$767, or 7.3%, increase to \$11,265 in 2005 from \$10,498 in 2004. The increase in 2006 was primarily attributable to higher benefits expense, particularly pension expense and health insurance premiums. This increase was offset by a decrease of \$73 in expense related to the employee stock ownership plan. Salary costs declined \$7 in 2006, as the number of employees dropped due to retirements and attrition. Approximately \$255 of the 2005 increase was from the addition of a number of employees in acquisitions in 2004 and 2005. Higher benefits expense added \$179 to the increased total at December 31, 2005.

Occupancy and furniture and fixtures expense was \$1,957 at December 31, 2006. This represents an increase of \$26 or 1.4% when compared with the \$1,931 total for the same period in 2005. Occupancy and furniture and fixtures expense in 2005 increased by \$134 or 7.5% from \$1,797 at December 31, 2004. Occupancy expense includes items such as depreciation expense, maintenance and repairs and real estate taxes. There was very little change in this category from 2005 to 2006. The costs of a new Company-wide telephone system and of fixed assets purchased in branch acquisitions in 2005 contributed to the increase from 2004 to 2005.

Data processing and ATM expense was \$1,234 in 2006, \$1,455 in 2005 and \$1,302 in 2004. The \$221 or 15.2% decline from the 2005 total in this category came about because 2005 expenses included \$152 in extraordinary costs attributable to the conversion of the Community National Bank computer system that was acquired in 2004, as well as servicing fees of \$47 paid to Community National's data processor prior to the date of the conversion.

Credit card processing expense was \$1,833 for the period ended December 31, 2006, an increase of \$146 or 8.7% over 2005. At December 31, 2005, credit card processing expense was \$1,687, an increase of \$185 over the \$1,502 in that category at the same period in 2004. Increases in 2006 and in 2005 were attributable to a larger volume of credit card, debit card and merchant card accounts and transactions.

From 2005 to 2006, there was an increase of \$20 or 1.8% in intangible and goodwill expense. At the end of 2006, the total in this category was \$1,137, as

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compared with \$1,117 in 2005 and \$967 in 2004. This category of noninterest expense is related to acquisitions. The increase in 2006 reflects the fact that the expenses related to 2005 acquisitions were included for the full year. Similarly, the 2005 increase reflects expenses related to 2005 acquisitions as well as the full year's effects of acquisitions completed in 2004.

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Net costs of other real estate owned declined by \$256 or 93.1%, from \$275 in 2005 to \$19 in 2006. This follows an increase in 2005 of \$74 from the \$201 recorded in 2004. Net costs of other real estate owned come from the write-down and liquidation of foreclosed properties. These costs were lower in 2006 because the Company had fewer parcels of other real estate owned, and there were not many sales during the year. Costs were higher in 2005 than in 2004 because of the costs associated with the disposition of several foreclosed properties.

The category of other operating costs includes a variety of items including franchise taxes, stationery and supplies, telephone costs, postage and charitable donations. The total of other operating costs at December 31, 2006 was \$4,024. This reflects a decrease of \$144 or 3.5% from December, 2005. The decrease was in large part due to cost containment measures. Other operating costs for the period ended December 31, 2005 were \$4,168, a nominal 2.4% increase over the \$4,069 total at December 31, 2004.

### Income Taxes

Income tax expense for 2006 was \$3,788. This is a decrease of \$136 or 3.5% when compared with 2005 income tax expense. Income tax expense increased \$170 from 2004 to 2005, from \$3,754 in 2004 to \$3,924 in 2005. Tax exempt income is the primary difference between expected and actual income tax expense. The Company's effective tax rates for 2006, 2005 and 2004 were 23.07%, 24.00% and 23.49%, respectively. The Company is subject to the 35% marginal tax rate. See Note 10 of the Notes to Consolidated Financial Statements for addition information relating to income taxes.

### Effects of Inflation

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

### Provision and Allowance for Loan Losses

The allowance for loan losses at December 31, 2006 was \$5,157, a \$292 decrease from the \$5,449 total at year end 2005. The allowance for loan losses at the end of 2005 was down by \$280 from the same period in the prior year. The ratio of the allowance for loan losses to total loans at year-end in 2006, 2005 and 2004 was 1.03%, 1.11% and 1.20%, respectively. The net charge-off ratio at December 31, 2006 was 0.07%. At December 31, 2005, it was 0.17%, and it was 0.30% at December 31, 2004.

The Company continuously monitors loan quality, and it regularly analyzes and evaluates the adequacy of the allowance for loan losses. The analysis of the allowance for loan losses includes calculations that are based on a mathematical formula that considers identified potential losses and that makes allocations to the allowance based upon historical losses in various loan categories. In addition, more subjective factors are considered in determining contributions to the allowance. These include such things as changes in the mix of categories of

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loans in the portfolio, the effects of internal loan policy changes, changes in business and economic conditions and the effects of competition and regulation on the loan portfolio. Over the past three years the quality of the loan portfolio has improved, as demonstrated in part by the declining net charge-off ratio. The decline in the ratio of the allowance for loan losses to total loans has tracked the improvement in the quality of the Company's loan portfolio. Because the overall quality of the loan portfolio was excellent and also because loan growth slowed, it is management's judgment that the decrease in the ratio of the allowance for loan losses to total loans and the decrease in 2006 in the allowance are justified. Management further believes that the level of the allowance for loan losses is appropriate and adequate.

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### IV. Summary of Loan Loss Experience

#### A. Analysis of the Allowance for Loan Losses

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

| (\$ in thousands)                                | December 31, |           |           |           |
|--|--------------|-----------|-----------|-----------|
|  | 2006         | 2005      | 2004      | 2003      |
| =====  | =====        | =====     | =====     | =====     |
| Average net loans outstanding                    | \$488,624    | \$487,130 | \$438,761 | \$408,100 |
| Balance at beginning of year                     | \$ 5,449     | \$ 5,729  | \$ 5,369  | \$ 5,369  |
| Charge-offs:                                     |              |           |           |           |
| Commercial and industrial loans                  | 101          | 373       | 533       | 533       |
| Real estate mortgage loans                       | 6            | 50        | 120       | 120       |
| Real estate construction loans                   | ---          | ---       | 24        | 24        |
| Loans to individuals                             | 352          | 678       | 873       | 873       |
| Total loans charged off                          | 459          | 1,101     | 1,550     | 1,550     |
| Recoveries:                                      |              |           |           |           |
| Commercial and industrial loans                  | 29           | 55        | 46        | 46        |
| Real estate mortgage loans                       | 1            | 35        | 31        | 31        |
| Real estate construction loans                   | ---          | ---       | ---       | ---       |
| Loans to individuals                             | 88           | 164       | 146       | 146       |
| Total recoveries                                 | 118          | 254       | 223       | 223       |
| Net loans charged off                            | 341          | 847       | 1,327     | 1,327     |
| Additions charged to operations                  | 49           | 567       | 1,189     | 1,189     |
| Acquisition of CNB                               | ---          | ---       | 498       | 498       |
| Balance at end of year                           | \$ 5,157     | \$ 5,449  | \$ 5,729  | \$ 5,369  |
| =====  | =====        | =====     | =====     | =====     |
| Net charge-offs to average net loans outstanding | 0.07%        | 0.17%     | 0.30%     | 0.33%     |
| =====  | =====        | =====     | =====     | =====     |

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

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### B. Allocation of the Allowance for Loan Losses

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

|                                 |                  | December 31,                                     |                  |  |                  |  |                  |      |
|---------------------------------|------------------|--|------------------|--|------------------|--|------------------|------|
|                                 |                  | 2006   |                  | 2005   |                  | 2004   |                  | 2003 |
| (\$ in thousands)               | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount | Percent of Loans in Each Category to Total Loans | Allowance Amount |      |
| Commercial and industrial loans | \$1,651          | 42.90%   | \$1,478          | 53.52%   | \$1,387          | 51.90%   | \$1,239          |      |
| Real estate mortgage loans      | 935              | 25.17%   | 1,212            | 23.79%   | 990              | 24.10%   | 970              |      |
| Real estate construction loans  | 342              | 6.75%  | 420              | 5.50%  | 359              | 5.22%  | 125              |      |
| Loans to individuals            | 1,867            | 25.18%   | 2,190            | 17.19%   | 2,016            | 18.78%   | 2,257            |      |
| Unallocated                     | 362              |  | 149              |  | 977              |  | 778              |      |
|                                 | \$5,157          | 100.0%   | \$5,449          | 100.00%  | \$5,729          | 100.00%  | \$5,369          |      |

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### Balance Sheet

On December 31, 2006, the Company had total assets of \$868,203, an increase of \$26,705 or 3.2% over the total of \$841,498 on December 31, 2005. For 2006, the growth in assets was entirely internally generated. Total assets at December



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31, 2005 were up by \$45,344 or 5.7% over the 2004 year-end total of \$796,154. Acquisitions in 2005 accounted for approximately \$22,000 of the growth in total assets that year.

### Loans

#### A. Types of Loans

|  | December 31,     |                  |                  |                  |
|--|------------------|------------------|------------------|------------------|
|  | 2006             | 2005             | 2004             | 2003             |
| Commercial and industrial loans            | \$215,244        | \$206,389        | \$192,993        | \$167,000        |
| Real estate mortgage loans                 | 126,302          | 117,421          | 115,388          | 87,000           |
| Real estate construction loans             | 33,840           | 27,116           | 25,009           | 28,000           |
| Loans to individuals                       | 126,316          | 142,598          | 145,419          | 124,000          |
| <b>Total loans</b>                         | <b>\$501,702</b> | <b>\$493,524</b> | <b>\$478,809</b> | <b>\$407,000</b> |
| Less unearned income and deferred fees     | (1,059)          | (913)            | (881)            | (500)            |
| <b>Total loans, net of unearned income</b> | <b>\$500,643</b> | <b>\$492,611</b> | <b>\$477,928</b> | <b>\$406,500</b> |
| Less allowance for loans losses            | (5,157)          | (5,449)          | (5,729)          | (5,000)          |
| <b>Total loans, net</b>                    | <b>\$495,486</b> | <b>\$487,162</b> | <b>\$472,199</b> | <b>\$401,500</b> |

#### B. Maturities and Interest Rate Sensitivities

|  | December 31, 2006 |                  |                |
|--|-------------------|------------------|----------------|
|  | <1 Year           | 1 - 5 Years      | After 5 Years  |
| Commercial and industrial                    | \$63,647          | \$129,049        | \$22,548       |
| Real estate construction                     | 25,152            | 8,688            | ---            |
|  | 88,799            | 137,737          | 22,548         |
| Less loans with predetermined interest rates | 30,261            | 18,523           | 13,320         |
| <b>Loans with adjustable rates</b>           | <b>\$58,538</b>   | <b>\$119,214</b> | <b>\$9,228</b> |

#### C. Risk Elements

##### Nonaccrual, Past Due and Restructured Loans

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

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|  | December 31, |        |          |          |
|--|--------------|--------|----------|----------|
|  | 2006         | 2005   | 2004     | 2003     |
| -----                                    |              |        |          |          |
| Nonaccrual loans:                        |              |        |          |          |
| Commercial and industrial                | \$ ---       | \$ 171 | \$ 354   | \$ ---   |
| Real estate mortgage                     | ---          | ---    | 40       | ---      |
| Loans to individuals                     | ---          | 7      | ---      | ---      |
| -----                                    |              |        |          |          |
| Total nonperforming loans                | \$ ---       | \$ 178 | \$ 394   | \$ ---   |
| -----                                    |              |        |          |          |
| Other real estate owned, net             | 390          | 376    | 895      | 1,000    |
| -----                                    |              |        |          |          |
| Total nonperforming assets               | \$ 390       | \$ 554 | \$ 1,289 | \$ 2,000 |
| -----                                    |              |        |          |          |
| Accruing loans past due 90 days or more: |              |        |          |          |
| Commercial and industrial                | \$ 338       | \$ 142 | \$ 321   | \$ ---   |
| Real estate mortgage                     | 274          | 247    | 258      | ---      |
| Loans to individuals                     | 69           | 157    | 175      | ---      |
| -----                                    |              |        |          |          |
|  | \$ 681       | \$ 546 | \$ 754   | \$ ---   |
| =====                                    |              |        |          |          |

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

Loan Loss Data Table

|   | 2006      | 2005      |
|---|-----------|-----------|
| -----   |           |           |
| Provision for loan losses   | \$ 49     | \$ 567    |
| -----   |           |           |
| Net charge-offs to average net loans  | 0.07%     | 0.17%     |
| -----   |           |           |
| Allowance for loan losses to loans, net of unearned income and deferred fees                          | 1.03%     | 1.11%     |
| -----   |           |           |
| Allowance for loan losses to nonperforming loans  | ---%      | 3,061.24% |
| -----   |           |           |
| Allowance for loan losses to nonperforming assets   | 1,322.31% | 983.57%   |
| -----   |           |           |
| Nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 0.08%     | 0.11%     |
| -----   |           |           |
| Nonaccrual loans  | \$ ---    | \$ 178    |
| -----   |           |           |
| Restructured loans  | ---       | ---       |
| -----   |           |           |
| Other real estate owned, net  | \$ 390    | \$ 376    |
| -----   |           |           |
| Total nonperforming assets  | \$ 390    | \$ 554    |

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-----  
 Accruing loans past due 90 days or more \$ 681 \$ 546  
 -----

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

At December 31, 2006, there were two loans of approximately \$2.3 million, which the Company considered to be potential problem loans. These loans are collateralized, and at December 31, 2006 they were performing in accordance with loan terms.

Securities

Securities available for sale were \$169,735 at December 31, 2006, compared with \$162,833 at December 31, 2005 and \$145,323 at December 31, 2004. This represents an increase of \$6,902 or 4.2% from 2005 to 2006 and an increase of \$17,510 or 12.0% from 2004 to 2005. During 2006, the Company sold \$799 in securities held to maturity. Sales in 2006 consisted of mortgage backed securities which had been substantially paid down. In 2005, credit quality concerns prompted the sale of \$3,312 in securities held to maturity.

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Maturities and Associated Yields

The following table presents the maturities for securities available for sale and held to maturity at their carrying values as of December 31, 2006 and weighted average yield for each range of maturities.

| (\$ in thousands except for % data)              | Maturities and Yields<br>December 31, 2006 |                 |                   |                 |
|--|--|-----------------|-------------------|-----------------|
|  | <1 Year                                    | 1-5 Years       | 5-10 Years        | > 10 Years      |
| Available for Sale                               |  |                 |                   |                 |
| U.S. Treasury                                    | \$ ---<br>---                              | \$ 957<br>2.65% | \$ 1,962<br>3.97% | \$ ---          |
| U.S. Government agencies                         | 7,118<br>4.71%                             | 15,546<br>4.77% | 2,926<br>4.47%    | 1,962<br>6.00%  |
| Mortgage-backed securities                       | ---  | 2,690<br>4.61%  | 15,851<br>4.82%   | 11,963<br>5.00% |
| States and political subdivision - taxable       | ---  | 1,006<br>4.36%  | 2,957<br>5.85%    | ---             |
| States and political subdivision - nontaxable(1) | 1,007<br>6.44%                             | 19,562<br>5.58% | 44,388<br>5.90%   | 7,118<br>5.00%  |
| Corporate  | 1,002<br>6.00%                             | 14,963<br>3.89% | 14,614<br>4.83%   | ---             |
| Federal Home Loan Bank stock                     | ---  | ---             | ---               | ---             |

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|   |          |           |           |         |
|---|----------|-----------|-----------|---------|
| Federal Reserve Bank stock                        | ---      | ---       | ---       |         |
|   | ---      | ---       | ---       |         |
| Other securities                                  | 2        | ---       | ---       |         |
|   | 4.97%    | ---       | ---       |         |
| Total   | 9,129    | 54,724    | 82,698    | 19,5    |
|   | 5.04%    | 4.76%     | 5.41%     | 5       |
| Held to Maturity                                  | ---      | ---       | ---       |         |
| U.S. Treasury                                     | ---      | ---       | ---       |         |
| U.S. Government agencies                          | ---      | 24,599    | 8,990     | 2,5     |
|   | ---      | 4.47%     | 5.29%     | 5       |
| Mortgage-backed securities                        | ---      | ---       | ---       | 2,5     |
|   | ---      | ---       | ---       | 5       |
| States and political subdivision - taxable        | ---      | ---       | 2,000     |         |
|   | ---      | ---       | 5.31%     |         |
| States and political subdivision - nontaxable (1) | 380      | 6,097     | 30,600    | 11,5    |
|   | 6.63%    | 5.97%     | 6.03%     | 5       |
| Corporate   | 1,504    | 8,448     | 4,674     | 2,5     |
|   | 6.46%    | 5.92%     | 4.49%     | 5       |
| Total   | \$ 1,884 | \$ 49,144 | \$ 46,264 | \$ 18,5 |
|   | 6.49%    | 5.21%     | 5.70%     | 5       |

(1) Rates shown represent weighted average yield on a fully taxable basis.

The majority of mortgage-backed securities and collateralized mortgage obligations held at December 31, 2006 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Financial Institution Examination Council's (FFIEC) high risk mortgage security test. These tests address possible fluctuations in the average life and variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each. Except for U.S. Government securities, the Company has no securities with any issuer that exceeds 10% of stockholders' equity.

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#### Deposits

Total deposits at December 31, 2006 were \$764,692, an increase of \$19,043 or 2.6% when compared with total deposits of \$745,649 at the end of 2005. From December 31, 2004, when total deposits were \$705,932, to December 31, 2005, total deposits increased \$39,717 or 5.6%. The increase in total deposits in 2006 was generated internally. Time deposits at December 31, 2006 were \$382,514, which represents an increase of \$29,426 or 8.3%. During 2006 the Company's banking affiliate had two time deposit products that offered special rates to customers. In addition, there has been considerable emphasis by the bank on building the deposit base. In 2005 approximately \$22 million of the increase came from the first quarter acquisition of two branch offices.

#### A. Average Amounts of Deposits and Average Rates Paid

Average amounts and average rates paid on deposit categories are presented

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below:

| (\$ in thousands)                      | December 31,       |                          |                    |                          |          |
|--|--------------------|--------------------------|--------------------|--------------------------|----------|
|  | 2006               |                          | 2005               |                          |          |
|  | Average<br>Amounts | Average<br>Rates<br>Paid | Average<br>Amounts | Average<br>Rates<br>Paid | Av<br>Am |
| Noninterest-bearing<br>demand deposits | \$ 108,977         | ---                      | \$ 114,186         | ---                      | \$ 9     |
| Interest-bearing<br>demand deposits    | 221,927            | 1.87%                    | 204,522            | 1.31%                    | 18       |
| Savings deposits                       | 51,745             | 0.50%                    | 57,836             | 0.45%                    | 5        |
| Time deposits                          | 358,422            | 3.94%                    | 347,471            | 3.23%                    | 32       |
| Average total<br>deposits              | \$741,071          | 2.93%                    | \$724,015          | 2.32%                    | \$66     |

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

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

| (\$ in thousands)                              | December 31, 2006   |                                   |                                    |             |
|--|---------------------|-----------------------------------|------------------------------------|-------------|
|  | 3 Months<br>or Less | Over 3 Months<br>Through 6 Months | Over 6 Months<br>Through 12 Months | Over 12 Mon |
| Total time<br>deposits of<br>\$100,000 or more | \$14,876            | \$28,890                          | \$53,553                           | \$3         |

Derivatives and Market Risk Exposures

The Company is not a party to derivative financial instruments with off-balance sheet risks such as futures, forwards, swaps, and options. The Company is a party to financial instruments with off-balance sheet risks such as commitments to extend credit, standby letters of credit, and recourse obligations in the normal course of business to meet the financing needs of its customers. See Note 14, of Notes to Consolidated Financial Statements for additional information relating to financial instruments with off-balance sheet risk. Management does not plan any future involvement in high risk derivative products. The Company has investments in mortgage-backed securities, principally

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GNMA's and FNMA's, with a fair value of approximately \$32,811. The Company had no structured notes as of December 31, 2006. See Note 3 of Notes to Consolidated Financial Statements for additional information relating to securities.

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

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

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

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

### Liquidity

Liquidity measures the Company's ability to provide sufficient cash flow to meet its financial commitments, to fund additional loan demand and to handle withdrawals of existing deposits. Sources of liquidity include deposits, loan principal and interest repayments, sales, calls and maturities of securities and short-term borrowing. The Company also has a line of credit with the Federal Home Loan Bank and with a correspondent bank, and it may borrow from the Federal Reserve Bank's discount window to provide liquidity. The Company maintained an adequate level of liquidity during 2006, 2005 and 2004.

Net cash provided by operating activities was \$14,121 for the year ended December 31, 2006. This compares to \$15,461 and \$23,334 at year-end 2005 and 2004, respectively.

Net cash used in investing activities was \$31,543 for 2006, and it was \$20,036 in 2005 and \$38,762 in 2004.

There were no acquisitions in 2006. In 2005, the Company obtained \$13,178 through acquisitions, and it used \$8,022 for acquisitions in 2004.

Net cash provided by financing activities was \$12,590 for the period ended December 31, 2006. For the period ended December 31, 2005, net cash provided by financing activities was \$12,197, and at the same period in 2004 it was \$16,188.

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

### Recent Accounting Pronouncements

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

### Capital Resources

Total stockholders' equity at December 31, 2006 was \$96,755, an increase of \$4,816 from December 31, 2005. Earnings of \$12,632, less dividend to stockholders of \$5,108 were the two largest factors in determining stockholders' equity. The Company repurchased stock totaling \$1,183 in 2006, and there were \$122 in stock options that were exercised. The Tier I and Tier II risk-based capital ratio at December 31, 2006 were 14.2% and 15.0%, respectively. The Company has other available sources of liquidity. They include lines of credit with a correspondent bank, advances from the Federal Home Loan Bank, and Federal Reserve Bank discount window borrowings.

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

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### Off-Balance Sheet Arrangements

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

|  | Total             | Payments Due by Period |            |            |
|--|-------------------|------------------------|------------|------------|
|  |                   | Less Than 1<br>Year    | 1-3 Years  | 3-5 Years  |
| Commitments to extend credit           | \$ 125,447        | 125,447                | ---        | ---        |
| Standby letters of credit              | 8,391             | 8,391                  | ---        | ---        |
| Mortgage loans with potential recourse | 19,022            | 19,022                 | ---        | ---        |
| Commitments to invest in LLC's         | 885               | 885                    | ---        | ---        |
| Operating leases                       | 913               | 215                    | 390        | 154        |
|  | ---               | ---                    | ---        | ---        |
| <b>Total</b>                           | <b>\$ 154,658</b> | <b>153,960</b>         | <b>390</b> | <b>154</b> |
|  | =====             | =====                  | ===        | ===        |

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

Standby letters of credit are also issued to the bank's customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation. Revenue from these letters was approximately \$30 in 2006.

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 can draw funds. A sale of loans would also be an option.

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

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

During the fourth quarter of 2005 the Company announced that it would merge its BTC affiliate into its NBB affiliate. This merger was completed in the second quarter of 2006. Management believes that greater operational efficiency has come from this merger and that more will come about as operations are fully integrated.

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Information about market risk is set forth above in the "Interest Rate Sensitivity" and "Derivatives and Market Risk Exposure" sections of the Management's Discussion and Analysis, which are in this report on pages 16 and 24, respectively.

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### Item 8. Financial Statements and Supplementary Data CONSOLIDATED BALANCE SHEETS

\$ In thousands, except share data.

|        |   | 2006      |    |
|--------|---|-----------|----|
| Assets | Cash and due from banks   | \$ 15,283 | \$ |
|        | Interest-bearing deposits   | 19,617    |    |
|        | Securities available for sale, at fair value  | 169,735   |    |
|        | Securities held to maturity (fair value approximates \$115,561 at December 31, 2006 and \$109,513 at December 31, 2005) | 115,754   |    |
|        | Mortgage loans held for sale  | 808       |    |
|        | Loans:  |           |    |
|        | Real estate construction loans  | 33,840    |    |
|        | Real estate mortgage loans  | 126,302   |    |
|        | Commercial and industrial loans   | 215,244   |    |
|        | Loans to individuals  | 126,316   |    |
|        | Total loans   | 501,702   |    |
|        | Less unearned income and deferred fees  | (1,059)   |    |
|        | Loans, net of unearned income and deferred fees   | 500,643   |    |
|        | Less allowance for loan losses  | (5,157)   |    |
|        | Loans, net  | 495,486   |    |



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|                 |   |                   |           |
|-----------------|---|-------------------|-----------|
|                 | Premises and equipment, net   | 12,702            |           |
|                 | Accrued interest receivable   | 5,682             |           |
|                 | Other real estate owned, net  | 390               |           |
|                 | Intangible assets and goodwill  | 15,976            |           |
|                 | Other assets  | 16,770            |           |
|                 | <b>Total assets</b>   | <b>\$ 868,203</b> | <b>\$</b> |
| Liabilities and | Noninterest-bearing demand deposits   | \$ 101,167        | \$        |
| Stockholders'   | Interest-bearing demand deposits  | 233,023           |           |
| Equity          | Saving deposits   | 47,988            |           |
|                 | Time deposits   | 382,514           |           |
|                 | <b>Total deposits</b>   | <b>764,692</b>    |           |
|                 | Other borrowed funds  | 73                |           |
|                 | Accrued interest payable  | 863               |           |
|                 | Other liabilities   | 5,820             |           |
|                 | <b>Total liabilities</b>  | <b>771,448</b>    |           |
|                 | Commitments and contingencies   |                   |           |
|                 | Stockholders' equity:   |                   |           |
|                 | Preferred stock, no par value, 5,000,000 shares authorized;<br>none issued and outstanding  | ---               |           |
|                 | Common stock of \$1.25 par value. Authorized<br>10,000,000 shares; issued and outstanding,<br>6,980,234 shares - 2006, and 7,019,874 - 2005 | 8,725             |           |
|                 | Retained earnings   | 91,123            |           |
|                 | Accumulated other comprehensive (loss), net   | (3,093)           |           |
|                 | <b>Total stockholders' equity</b>   | <b>96,755</b>     |           |
|                 | <b>Total liabilities and stockholders' equity</b>   | <b>\$ 868,203</b> | <b>\$</b> |

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

CONSOLIDATED STATEMENTS OF INCOME

\$ In thousands, except per share data.

Years ended

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|             |   | 2006      |    |
|-------------|---|-----------|----|
| Interest    | Interest and fees on loans                          | \$ 34,879 | \$ |
| Income      | Interest on federal funds sold                      | ---       |    |
|             | Interest on interest-bearing deposits               | 684       |    |
|             | Interest on securities - taxable                    | 7,462     |    |
|             | Interest on securities - nontaxable                 | 4,876     |    |
|             | Total interest income                               | 47,901    |    |
| Interest    | Interest on time deposits of \$100,000 or more      | 4,912     |    |
| Expense     | Interest on other deposits                          | 13,626    |    |
|             | Interest on borrowed funds                          | 26        |    |
|             | Total interest expense                              | 18,564    |    |
|             | Net interest income                                 | 29,337    |    |
|             | Provision for loan losses                           | 49        |    |
|             | Net interest income after provision for loan losses | 29,288    |    |
| Noninterest | Service charges on deposit accounts                 | 3,361     |    |
| Income      | Other service charges and fees                      | 370       |    |
|             | Credit card fees                                    | 2,396     |    |
|             | Trust income  | 1,528     |    |
|             | Other income  | 1,117     |    |
|             | Realized securities gains, net                      | 30        |    |
|             | Total noninterest income                            | 8,802     |    |
| Noninterest | Salaries and employee benefits                      | 11,466    |    |
| Expense     | Occupancy and furniture and fixtures                | 1,957     |    |
|             | Data processing and ATM                             | 1,234     |    |
|             | Credit card processing                              | 1,833     |    |
|             | Intangible assets and goodwill amortization         | 1,137     |    |
|             | Net costs of other real estate owned                | 19        |    |
|             | Other operating expenses                            | 4,024     |    |
|             | Total noninterest expense                           | 21,670    |    |
|             | Income before income taxes                          | 16,420    |    |

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|                                    |           |    |
|------------------------------------|-----------|----|
| Income tax expense                 | 3,788     |    |
| -----                              |           |    |
| Net income                         | \$ 12,632 | \$ |
| -----                              |           |    |
| Basic net income per share         | \$ 1.80   | \$ |
| -----                              |           |    |
| Fully diluted net income per share | \$ 1.80   | \$ |
| -----                              |           |    |

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

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

\$ In thousands, except per share data.

|   | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Co |
|---|--------------|-------------------|---|----|
| -----   |              |                   |   |    |
| Balance at December 31, 2003  | \$ 8,788     | \$ 70,063         | 1,790   |    |
| Net income  | ---          | 12,230            | ---   | \$ |
| Other comprehensive loss:   |              |                   |   |    |
| Unrealized holding losses on available for sale securities net of deferred taxes of \$(516)   | ---          | ---               | ---   |    |
| Less: reclassification adjustment, net of income taxes of \$7                                 | ---          | ---               | ---   |    |
| Minimum pension liability adjustment net of deferred taxes of \$(155)                         | ---          | ---               | ---   |    |
| Other comprehensive loss, net of tax of \$(664)   | ---          | ---               | (1,234)                                       |    |
| Total comprehensive income  | ---          | ---               | ---   | \$ |
| Cash dividends (\$0.64 per share)   | ---          | (4,504)           | ---   |    |
| Exercise of stock options   | 22           | 150               | ---   |    |
| Common stock repurchase   | (13)         | (204)             | ---   |    |
| Balance at December 31, 2004  | \$ 8,797     | \$ 77,735         | \$ 556  |    |
| Net income  | ---          | 12,424            | ---   | \$ |
| Other comprehensive loss:   |              |                   |   |    |
| Unrealized holding losses on available for sale securities net of deferred taxes of \$(1,026) | ---          | ---               | ---   |    |
| Less: reclassification adjustment, net of income taxes of \$(66)                              | ---          | ---               | ---   |    |
| Minimum pension liability adjustment, net of deferred taxes of \$14                           | ---          | ---               | ---   |    |
| Other comprehensive loss, net of tax of \$(1,078)   | ---          | ---               | (2,002)                                       |    |
| Total comprehensive income  | ---          | ---               | ---   | \$ |
| Cash dividend (\$0.71 per share)  | ---          | (4,991)           | ---   |    |
| Exercise of stock options   | 17           | 147               | ---   |    |
| Common stock repurchase   | (39)         | (705)             | ---   |    |
| Balance at December 31, 2005  | \$ 8,775     | \$ 84,610         | \$ (1,446)                                    |    |
| Net income  | ---          | 12,632            | ---   | \$ |

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|   |          |           |            |
|---|----------|-----------|------------|
| Other comprehensive loss:   |          |           |            |
| Unrealized holding gains on available for sale securities net of deferred taxes of \$83 | ---      | ---       | ---        |
| Less: reclassification adjustment, net of income taxes of \$3                           | ---      | ---       | ---        |
| Minimum pension liability adjustment, net of deferred taxes of \$(973)                  | ---      | ---       | ---        |
| Other comprehensive loss, net of tax of \$(887)   | ---      | ---       | (1,647)    |
| Total comprehensive income  | ---      | ---       | ---        |
| Cash dividend (\$0.73 per share)  | ---      | (5,108)   | ---        |
| Exercise of stock options   | 13       | 109       | ---        |
| Common stock repurchase   | (63)     | (1,120)   | ---        |
| Balance at December 31, 2006  | \$ 8,725 | \$ 91,123 | \$ (3,093) |

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

|                  |  | Years Ended December 31, |          |
|------------------|--|--------------------------|----------|
|                  |  |                          | 2006     |
|                  |  |                          | -----    |
| \$ In thousands. |  |                          |          |
| Cash             | Net income   |                          | \$ 12,63 |
| Flows            | Adjustment to reconcile net income to net cash provided by             |                          |          |
| from             | operating activities:  |                          |          |
| Operating        | Provision for loan losses  |                          | 4        |
| Activities       | Deferred income tax expense (benefit)                                  |                          | 24       |
|                  | Depreciation of premises and equipment                                 |                          | 99       |
|                  | Amortization of intangibles  |                          | 1,13     |
|                  | Amortization of premiums and accretion of discounts, net               |                          | 25       |
|                  | (Gains) losses on sale and calls of securities available for sale, net |                          |          |
|                  | (Gains) losses on calls of securities held to maturity, net            |                          | (3       |
|                  | Losses and writedowns on other real estate owned                       |                          | 1        |
|                  | Originations of mortgage loans held for sale                           |                          | (19,83   |
|                  | Sales of mortgage loans held for sale                                  |                          | 19,02    |
|                  | Losses on sale and disposal of fixed assets                            |                          | (        |
|                  | Net change in:   |                          |          |
|                  | Accrued interest receivable  |                          | (537     |
|                  | Other assets   |                          | (173     |
|                  | Accrued interest payable   |                          | 138      |
|                  | Other liabilities  |                          | 212      |
|                  | Net cash provided by operating activities                              |                          | 14,121   |
| Cash             | Net change in interest-bearing deposits                                |                          | (9,338   |
| Flows            | Proceeds from repayments of mortgage-backed securities                 |                          | 6,50     |
| from             | Proceeds from sales of securities available for sale                   |                          | 1,47     |
| Investing        | Proceeds from calls and maturities of securities available             |                          |          |
| Activities       | for sale   |                          | 11,44    |
|                  | Proceeds from calls and maturities of securities held to maturity      |                          | 9,42     |
|                  | Proceeds from the sale of securities held to maturity                  |                          | 79       |
|                  | Purchases of securities available for sale                             |                          | (24,22   |

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|              |   |          |
|--------------|---|----------|
|              | Purchases of securities held to maturity                | (18,35   |
|              | Purchases of loan participations                        | (2,23    |
|              | Collections of loan participations                      | 3,80     |
|              | Acquisitions, net of cash received                      | --       |
|              | Loan originations and principal collections, net        | (10,08   |
|              | Purchase of bank owned life insurance                   | --       |
|              | Proceeds from disposal of other real estate owned       | --       |
|              | Recoveries on loans charged off                         | 11       |
|              | Additions to premises and equipment                     | (88      |
|              | Proceeds from sale of premises and equipment            |          |
|              | Net cash used by investing activities                   | (31,54   |
| Cash         | Net change in time deposits                             | 29,42    |
| Flows        | Net change in other deposits                            | (10,38   |
| from         | Net change in other borrowed funds                      | (28      |
| Financing    | Cash dividends paid                                     | (5,10    |
| Activities   | Common stock repurchase                                 | (1,18    |
|              | Stock options exercised                                 | 12       |
|              | Net cash provided by financing activities               | 12,59    |
| Supplemental | Net change in cash and due from banks                   | (4,83    |
| Disclosures  | Cash and due from banks at beginning of year            | 20,11    |
| of Cash Flow | Cash and due from banks at end of year                  | \$ 15,28 |
| Information  | Interest paid on deposits and borrowed funds            | \$ 18,42 |
|              | Income taxes paid                                       | 3,37     |
| Supplemental | Loans charged against the allowance for loan losses     | 45       |
| Disclosures  | Loans transferred to other real estate owned            | 2        |
| of Noncash   | Unrealized gain (loss) on securities available for sale | 24       |
| Activities   | Minimum pension liability adjustment                    | (2,77    |
|              | Transactions related to acquisitions:                   |          |
|              | Increase in assets and liabilities:                     |          |
|              | Investments   | --       |
|              | Loans   | --       |
|              | Deposits  | --       |

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

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

### Note 1: Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of National Bankshares, Inc. (Bankshares) and its wholly-owned subsidiaries, the National Bank of Blacksburg (NBB), and National Bankshares Financial Services, Inc. (NBFS), (the Company). All significant intercompany balances and transactions have been eliminated in consolidation. Until May 26, 2006 the Company conducted its operations through two full-service banking affiliates, the National Bank of Blacksburg and Bank of Tazewell County. On May 26, 2006 Bank of Tazewell was merged with and into the National Bank.

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

#### Cash and Cash Equivalents

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

#### Securities

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Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. The Company has no securities classified as trading securities at December 31, 2006 or 2005.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. The Company evaluates the securities portfolio for possible impairment on an on going basis. Losses are attributable to interest rate movements. These losses are not considered other than temporary. Credit quality of the securities portfolio is continuously monitored by management.

### Loans Held for Sale

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

### Loans

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

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

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

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

### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience; the nature, volume, and risk characteristics of the loan portfolio; adverse situations that may affect the borrower's ability to repay; estimated value of any underlying collateral; and

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prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

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The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

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

### Rate Lock Commitments

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

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

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### Premises and Equipment

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

### Other Real Estate

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

### Intangible Assets

Included in other assets are deposit intangibles of \$10,008 and \$11,108 at December 31, 2006 and 2005, respectively, and goodwill of \$5,968 and \$6,005 at December 31, 2006 and 2005, respectively. Deposit intangibles are being amortized on a straight-line basis over a ten- or twelve-year period, and goodwill still being amortized on a straight-line basis is over a fifteen-year period. Goodwill from the CNB acquisition in 2004 is not being amortized, but is subject to annual impairment testing.

### 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 NBI 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 December 31, 2006, there were 286,000 additional shares available for grant under the plan.



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amortized over the requisite service period using the straight-line method.

There have been no grants of stock options in 2006.

|   | Years Ended December 31,              |           |
|---|---------------------------------------|-----------|
|   | 2005                                  | 2004      |
|   | (In thousands, except per share data) |           |
| Net income as reported  | \$ 12,424                             | \$ 12,230 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards | (594)                                 | (102)     |
| Pro forma net income  | \$ 11,830                             | \$ 12,128 |
| Earnings per share:   |                                       |           |
| Basic-as reported   | \$ 1.77                               | \$ 1.74   |
| Basic-pro forma   | \$ 1.69                               | \$ 1.73   |
| Diluted-as reported   | \$ 1.76                               | \$ 1.73   |
| Diluted-pro forma   | \$ 1.68                               | \$ 1.72   |

During the twelve months ended December 31, 2006, there were no stock options granted and 10,710 stock options were exercised with an intrinsic value of \$136,000.

### Pension Plan

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.

### Income Taxes

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

## Trust Assets and Income

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

## Earnings Per Share

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

Effective on March 31, 2006, National Bankshares, Inc.'s Board of Directors approved a 2-for-1 stock split of Bankshares' common stock. All per share information for all periods presented has been retroactively restated to reflect the stock split.

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

|  | 2006<br>----       | 2005<br>----       | 2004<br>----       |
|--|--------------------|--------------------|--------------------|
| Average number of common shares outstanding  | 7,000,695          | 7,029,058          | 7,035,964          |
| Effect of dilutive options   | 24,040<br>-----    | 32,628<br>-----    | 39,888<br>-----    |
| Average number of common shares outstanding used to calculate diluted earnings per share | 7,024,735<br>===== | 7,061,686<br>===== | 7,075,852<br>===== |

In 2006, 2005 and 2004 stock options representing 65,250, 54,000 and 26,250 shares as restated for the 2-for-1 stock split, respectively, were not included in the computation of diluted net income per share because to do so would have been anti-dilutive.

## Advertising

The Company practices the policy of charging advertising costs to expenses as incurred. In 2006, the Company charged \$204 to expenses, and in 2005 and 2004, \$210 and \$226 was expensed, respectively.

## Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate and deferred tax assets.

Changing economic conditions, adverse economic prospects for borrowers, as

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

Certain reclassifications have been made to prior period balances to conform to the current year provisions.

### Recent Accounting Pronouncements

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. 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. 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 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 implementation of this pronouncement will have no material effect on the Company's 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. 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 consolidated financial statements.

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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

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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 implementation of this pronouncement will have no material effect on the Company's financial statements.

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 consolidated 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. Implementation of this pronouncement resulted in a change in the Company's accumulated comprehensive income of approximately \$2,707.

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 that are not certain to be realized. FIN 48 is effective for fiscal years beginning after December 15, 2006. The implementation of this pronouncement will have no material effect on the Company's financial statements.

In September 2006, the Emerging Issues Task Force issued EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with FASB Statement No. 106 (if, in substance, a postretirement benefit plan exits) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the effect that EITF No.

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06-4 will have on its consolidated financial statements when implemented.

In September 2006, The Emerging Issues Task Force issued EITF 06-5, "Accounting for Purchases of Life Insurance- Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 ." This consensus concludes that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. A consensus also was reached that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The consensuses are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect that EITF No. 06-5 will have on its consolidated financial statements when implemented.

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Note 2: Restriction on Cash

As members of the Federal Reserve System, the Company's subsidiary bank is required to maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2006 and 2005, the aggregate amounts of daily average required balances approximated \$350 and \$5,884, respectively.

Note 3: Securities

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

| Available for sale:  | Amortized<br>Cost | December 31, 20<br>Gross<br>Unrealized<br>Gains | Gr<br>Unrea<br>Los |
|--|-------------------|---|--------------------|
| U.S. Treasury  | \$ 3,033          | \$ ---  | \$                 |
| U.S. Government agencies and corporations<br>States and political subdivisions | 26,799            | 3   |                    |
| Mortgage-backed securities   | 75,566            | 914   |                    |
| Corporate debt securities  | 30,652            | 12  |                    |
| Federal Home Loan Bank stock-restricted  | 31,530            | 95  | 1,                 |
| Federal Reserve Bank stock-restricted  | 1,822             | ---   |                    |
| Other securities   | 92                | ---   |                    |
|  | 1,274             | 127   |                    |
|  | -----             | ---   |                    |
| Total securities available for sale  | \$ 170,768        | \$ 1,151  | \$ 2,              |
|  | =====             | =====   | =====              |

| Available for sale:                       | Amortized Cost | December 31, 20<br>Gross<br>Unrealized Gains | Unr<br>L |
|---|----------------|--|----------|
| U.S. Treasury                             | \$ 4,037       | \$ 3   |          |
| U.S. Government agencies and corporations | 22,774         | ---  |          |

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|   |            |          |
|---|------------|----------|
| States and political subdivisions       | 74,238     | 1,035    |
| Mortgage-backed securities              | 27,323     | 95       |
| Corporate debt securities               | 32,090     | 122      |
| Federal Home Loan Bank stock-restricted | 1,671      | ---      |
| Federal Reserve Bank stock-restricted   | 209        | ---      |
| Other securities                        | 1,770      | 157      |
|   | -----      | ---      |
| Total securities available for sale     | \$ 164,112 | \$ 1,412 |
|   | =====      | =====    |

The amortized cost and fair value of single maturity securities available for sale at December 31, 2006, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2006.

|  | December 31, 2006 |               |
|--|-------------------|---------------|
|  | Amortized<br>Cost | Fair<br>Value |
|  | -----             | -----         |
| Due in one year or less                | \$ 10,156         | \$ 9,129      |
| Due after one year through five years  | 56,412            | 54,724        |
| Due after five years through ten years | 81,065            | 82,698        |
| Due after ten years                    | 19,946            | 19,871        |
| No maturity                            | 3,186             | 3,315         |
|  | -----             | -----         |
|  | \$ 170,765        | \$ 169,735    |
|  | =====             | =====         |

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

|   | December 31, 2006 |                              |                               |
|---|-------------------|------------------------------|-------------------------------|
|   | Amortized Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|   | -----             | -----                        | -----                         |
| Held to maturity:                         |                   |                              |                               |
| U.S. Government agencies and corporations | \$ 36,457         | \$ 9                         | \$ 58                         |
| States and political subdivisions         | 60,182            | 853                          | 19                            |
| Mortgage-backed securities                | 2,489             | 10                           | 2                             |
| Corporate debt securities                 | 16,626            | 180                          | 44                            |
|   | -----             | ---                          | ---                           |
| Total securities held to maturity         | \$ 115,754        | \$1,052                      | \$ 1,24                       |
|   | =====             | =====                        | =====                         |

|                   | December 31, 2005 |                              |                               |
|-------------------|-------------------|------------------------------|-------------------------------|
|                   | Amortized Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|                   | -----             | -----                        | -----                         |
| Held to maturity: |                   |                              |                               |

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|   |            |         |          |
|---|------------|---------|----------|
| U.S. Government agencies and corporations | \$ 28,603  | \$ ---  | \$ 633   |
| States and political subdivisions         | 56,898     | 891     | 262      |
| Mortgage-backed securities                | 3,994      | 54      | 35       |
| Corporate debt securities                 | 20,213     | 316     | 526      |
|   | -----      | ---     | ---      |
| Total securities held to maturity         | \$ 109,708 | \$1,261 | \$ 1,456 |
|   | =====      | =====   | =====    |

The amortized cost and fair value of single maturity securities held to maturity at December 31, 2006, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2006.

|  | December 31, 2006 |            |
|--|-------------------|------------|
|  | Amortized Cost    | Fair Value |
|  | -----             | -----      |
| Due in one year or less                | \$ 1,884          | \$ 1,893   |
| Due after one year through five years  | 49,144            | 48,987     |
| Due after five years through ten years | 46,264            | 46,439     |
| Due after ten years                    | 18,462            | 18,242     |
|  | -----             | -----      |
|  | \$ 115,754        | \$115,561  |
|  | =====             | =====      |

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

|  | December 31, 2006              |                 |                              |                 |
|--|--------------------------------|-----------------|------------------------------|-----------------|
|  | Less Than 12 Months Fair Value | Unrealized Loss | 12 Months or More Fair Value | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 22,734                      | 83              | \$ 38,234                    |                 |
| State and political subdivisions           | 14,449                         | 91              | 30,503                       |                 |
| Mortgage-backed securities                 | 13,533                         | 46              | 16,268                       |                 |
| Corporate debt securities                  | ---                            | ---             | 35,462                       | 1               |
|  | ---                            | ---             | -----                        | ---             |
| Total temporarily impaired securities      | \$ 50,716                      | 220             | \$ 120,467                   | 3               |
|  | =====                          | ===             | =====                        | ---             |

|  | December 31, 2005              |                 |                              |                 |
|--|--------------------------------|-----------------|------------------------------|-----------------|
|  | Less Than 12 Months Fair Value | Unrealized Loss | 12 Months or More Fair Value | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 38,913                      | 541             | \$ 11,698                    |                 |
| State and political subdivisions           | 28,660                         | 429             | 15,625                       |                 |

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|                                       |            |       |           |
|---------------------------------------|------------|-------|-----------|
| Mortgage-backed securities            | 22,169     | 333   | 3,132     |
| Corporate debt securities             | 12,052     | 200   | 25,881    |
|                                       | -----      | ---   | -----     |
| Total temporarily impaired securities | \$ 101,794 | 1,503 | \$ 56,336 |
|                                       | =====      | ===== | =====     |

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The Company had 241 securities with a fair value of \$171,183 which were temporarily impaired at December 31, 2006. The total unrealized loss on these securities was \$3,429. Losses are attributed to interest rate movements. Credit quality of the securities portfolio is continuously monitored by management. The Company has the ability and intent to hold these securities until maturity. Therefore, the losses associated with these securities are not considered other than temporary at December 31, 2006.

At December 31, 2006 and 2005, securities with a carrying value of \$67,325 and \$60,409, respectively, were pledged to secure trust deposits and for other purposes as required or permitted by law.

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 totaling approximately \$100,890, and NBB's capital stock investment in the FHLB.

Note 4: Loans to Officers and Directors

In the ordinary course of business, the Company, through its banking subsidiary, has granted loans to executive officers and directors of Bankshares and its subsidiaries amounting to \$2,524 at December 31, 2006 and \$3,941 at December 31, 2005. During the year ended December 31, 2006 total principal additions were \$1,918 and principal payments were \$3,335.

Note 5: Allowance for Loan Losses

An analysis of the allowance for loan losses follows:

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2005                     | 2005     | 2004     |
|  | -----                    | -----    | -----    |
| Balance at beginning of year               | \$ 5,449                 | \$ 5,729 | \$ 5,369 |
| Provision for loan losses                  | 49                       | 567      | 1,189    |
| Loans charged off                          | (459)                    | (1,101)  | (1,550)  |
| Recoveries of loans previously charged off | 118                      | 254      | 223      |
| Acquisition of bank                        | ---                      | ---      | 498      |
| Balance at end of year                     | \$ 5,157                 | \$ 5,449 | \$ 5,729 |

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

|  | December 31, |       |       |
|--|--------------|-------|-------|
|  | 2006         | 2005  | 2004  |
|  | -----        | ----- | ----- |



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|   |        |        |        |
|---|--------|--------|--------|
| Impaired loans without a valuation allowance  | \$ --- | \$ 174 | \$ 275 |
| Impaired loans with a valuation allowance     | ---    | ---    | 79     |
| Total impaired loans                          | \$ --- | \$ 174 | \$ 354 |
|   | =====  | =====  | =====  |
| Valuation allowance related to impaired loans | \$ --- | \$ --- | \$ 55  |
|   | =====  | =====  | =====  |

|  | Years ended December 31, |       |       |
|--|--------------------------|-------|-------|
|  | 2006                     | 2005  | 2004  |
|  | -----                    | ----- | ----- |
| Average investment in impaired loans                         | \$140                    | \$274 | \$    |
| Interest income recognized on impaired loans                 | ---                      | ---   |       |
| Interest income recognized on a cash basis on impaired loans | ---                      | 11    |       |
|  | -----                    | ----- | ----- |

No additional funds are committed to be advanced in connection with impaired loans. Nonaccrual loans excluded from impaired loan disclosure under FASB 114 at December 31, 2006 and 2005 were \$0 and \$7, respectively. If interest on these loans had been accrued, the income would have been \$0 and \$0 respectively. Loans past due greater than 90 days which continue to accrue interest totaled \$681 and \$546 at December 31, 2006 and 2005, respectively.

Note 6: Premises and Equipment

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

|                          | December 31, |           |
|--------------------------|--------------|-----------|
|                          | 2006         | 2005      |
|                          | -----        | -----     |
| Premises                 | \$ 14,320    | \$ 14,028 |
| Furniture and equipment  | 11,029       | 10,324    |
| Construction-in-progress | 270          | 460       |
|                          | \$ 25,619    | \$ 24,812 |
| Accumulated depreciation | (12,917)     | (12,004)  |
|                          | -----        | -----     |
|                          | \$ 12,702    | \$ 12,808 |
|                          | =====        | =====     |

Depreciation expense for the years ended December 2006, 2005 and 2004 amounted to \$992, \$1,017 and \$953, respectively.

The Company leases branch facilities under noncancellable operating leases. The future minimum lease payments under these leases (with initial or remaining lease terms in excess of one year) as of December 31, 2006 are as follows: \$215 in 2007, \$210 in 2008, \$180 in 2009, \$124 in 2010, \$30 in 2011, and \$154 thereafter.

Note 7: Deposits

The aggregate amounts of time deposits in denominations of \$100 or more at December 31, 2006 and 2005 were \$130,682 and \$114,969, respectively.

At December 31, 2006 the scheduled maturities of time deposits are as follows:

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|            |            |
|------------|------------|
| 2007       | \$ 268,982 |
| 2008       | 39,987     |
| 2009       | 25,317     |
| 2010       | 29,681     |
| 2011       | 16,182     |
| Thereafter | 2,365      |
|            | -----      |
|            | \$ 382,514 |

At December 31, 2006 and 2005, overdraft demand deposits reclassified to loans totaled \$639 and \$491, respectively.

### Note 8: Employee Benefit Plans

#### 401(k) Plan

The Company has a Retirement Accumulation Plan qualifying under IRS Code Section 401(k), in which Bankshares, NBB and NBFS are participating employers. Eligible participants may contribute up to 100% of their total annual compensation to the plan. Employee contributions are matched by the employer based on a percentage of an employee's total annual compensation contributed to the plan. For the years ended December 31, 2006, 2005 and 2004, the Company contributed \$278, \$275 and \$260, respectively, to the plan.

#### Employee Stock Ownership Plan

Bankshares has a nonleveraged Employee Stock Ownership Plan (ESOP) which enables employees of Bankshares and its subsidiaries who have one year of service and who have attained the age of 21 prior to the plan's January 1 and July 1 enrollment dates to own Bankshares common stock. Contributions to the ESOP which are not mandatory, are determined annually by the Board of Directors. Contribution expense amounted to \$300, \$373 and \$410 in the years ended December 31, 2006, 2005 and 2004, respectively. Dividends on ESOP shares are charged to retained earnings. As of December 31, 2006, the number of allocated shares held by the ESOP was 232,752 and the number of unallocated shares was 8,218. All shares held by the ESOP are treated as outstanding in computing the Company's basic net income per share. Upon reaching age 55 with ten years of plan participation, a vested participant has the right to diversify 50% of his or her allocated ESOP shares and Bankshares or the ESOP, with the agreement of the Trustee, is obligated to purchase those shares. The ESOP contains a put option which allows a withdrawing participant to require Bankshares or the ESOP, if the plan administrator agrees, to purchase his or her allocated shares if the shares are not readily tradable on an established market at the time of its distribution.

#### Defined Benefit Plan

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

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|   | December 31, |           |
|---|--------------|-----------|
|   | 2006         | 2005      |
| Change in benefit obligation                      |              |           |
| Projected benefit obligation at beginning of year | \$ 10,732    | \$ 10,220 |

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|   |          |          |
|---|----------|----------|
| Service cost  | 574      | 572      |
| Interest cost   | 648      | 585      |
| Actuarial (gain)/loss   | 107      | 444      |
| Benefits paid   | (332)    | (1,089)  |
| Projected benefit obligation at end of year   | 11,729   | 10,732   |
| Change in plan assets   |          |          |
| Fair value of plan assets at beginning of year  | 6,228    | 6,392    |
| Actual return on plan assets  | 699      | 420      |
| Employer contribution   | 1,240    | 505      |
| Benefits paid   | (332)    | (1,089)  |
| Fair value of plan assets at end of year  | 7,835    | 6,228    |
| Deferred asset (gain)/loss  | (171)    | 126      |
| Funded status at the end of the year  | (3,894)  | (4,504)  |
| Amounts recognized in the Statement of Financial Position   |          |          |
| Other liabilities   | (3,894)  | (1,562)  |
| Amount recognized   | (3,894)  | (1,562)  |
| Amounts recognized in accumulated other comprehensive income  |          |          |
| Net (gain)/loss   | 3,697    | 969      |
| Prior service cost  | 37       | 46       |
| Net obligation at transition  | (51)     | (64)     |
| Amount recognized   | 3,683    | 951      |
| Funded status   |          |          |
| Benefit obligation  | (11,729) | (10,732) |
| Fair value of assets  | 7,835    | 6,228    |
| Unrecognized net actuarial (gain)/loss  | 3,697    | 3,981    |
| Unrecognized net obligation at transition   | (51)     | (63)     |
| Unrecognized prior service cost   | 37       | 46       |
| (Accrued) benefit cost included in other liabilities  | (211)    | (541)    |
| Components of net periodic benefit cost   |          |          |
| Service cost  | 573      | 572      |
| Interest cost   | 648      | 585      |
| Expected return on plan assets  | (527)    | (547)    |
| Amortization of prior service cost  | 9        | 9        |
| Amortization of net obligation at transition  | (13)     | (13)     |
| Recognized net actuarial (gain)/loss  | 221      | 152      |
| Net periodic benefit cost   | 911      | 758      |
| Other changes in plan assets and benefit obligations recognized in other comprehensive income                     |          |          |
| Net (gain)/loss   | 2,777    | (44)     |
| Amortization of prior service cost  | (9)      | (9)      |
| Amortization of net obligation at transition  | 12       | 12       |
| Deferred income tax benefit (expenses)  | (974)    | 14       |
| Total recognized in other comprehensive income  | 1,806    | (27)     |
| Total recognized in net periodic benefit cost and other comprehensive income, net of income tax benefit (expense) | 2,720    | 731      |
| Weighted average assumptions at end of the year   |          |          |
| Discount rate used for net periodic pension cost  | 6.00%    | 6.00%    |
| Discount rate used for disclosure   | 6.00%    | 6.00%    |
| Expected return on plan assets  | 9.00%    | 9.00%    |
| Rate of compensation increase   | 4.00%    | 4.00%    |

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Incremental Effect of Applying SFAS No. 158 on Individual Line Items in the Consolidated

|  | December 31, 2006     |             |
|--|-----------------------|-------------|
|  | Before Application of | Adjustments |
|  | SFAS No. 158          |             |
|  | -----                 |             |
| Other assets (deferred income taxes)   | \$ 1,790              | \$ 1,289    |
| Total assets                           | 866,914               | 1,289       |
| Other liabilities (pension liability)  | 211                   | 3,683       |
| Total liabilities                      | 767,765               | 3,683       |
| Accumulated other comprehensive (loss) | (699)                 | (2,394)     |
| Total stockholders' equity             | 99,149                | (2,394)     |

Long Term Rate of Return

The Company, as plan sponsor, selects the expected long-term rate-of-return-on-assets assumption in consultation with its investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience, which may not continue over the measurement period, but other higher significance is placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, and solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

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

The pension plan's weighted average asset allocations at October 31, 2006 and 2005 are as follows:

| Asset Allocation             | 2006  | 2005 |
|------------------------------|-------|------|
|                              | ----- |      |
| U. S. Government obligations | 19%   | 17%  |
| Mutual funds - equity        | 24%   | 30%  |
| Corporate bonds              | 12%   | 14%  |
| Equity securities            | 36%   | 33%  |

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|       |      |      |
|-------|------|------|
| Other | 9%   | 6%   |
|       | ---  | ---  |
|       | 100% | 100% |
|       | ==== | ==== |

The Company expects to contribute \$722 to the plan in 2007.

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

|             |       |
|-------------|-------|
| 2007        | \$ 78 |
| 2008        | 81    |
| 2009        | 137   |
| 2010        | 326   |
| 2011        | 383   |
| 2012 - 2016 | 3,462 |

### Note 9: Stock Option Plan

The Company adopted the National Bankshares, Inc. 1999 Stock Option Plan to give key employees of Bankshares and its subsidiaries an opportunity to acquire shares of National Bankshares, Inc. common stock. The purpose of the 1999 Stock Option Plan is to promote the success of Bankshares and its subsidiaries by providing an incentive to key employees that enhances the identification of their personal interest with the long term financial success of the Company and with growth in stockholder value. Under the 1999 Stock Option Plan, up to 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 Bankshares 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 (as restated for the 2-for-1 stock split on March 31, 2006) previously granted, but unvested, stock options be immediately vested. The vesting was made subject to the provision that any shares of NBI common stock obtained by an option grantee by exercise of an option subject to accelerated vesting may not be sold or otherwise transferred prior to the expiration of the option's original vesting period. This action was taken to reduce the impact of the "Statement of Financial Accounting Standards No. 123R, Share-Based Payment" on the Company's earnings over the remainder vesting period of the stock options. At the discretion of the Stock Option Committee, options may be awarded with the provision that they may be accelerated upon a change of control, merger, consolidation, sale or dissolution of National Bankshares, Inc. Effective on April 1, 2006, the number of shares and the option price of all previously-granted options were adjusted to reflect the effects of the March 31, 2006 2-for-1 stock split. This action was taken to comply with the terms of the Company's stock option agreements. The information that follows also has been adjusted to reflect the effects of the March 31, 2006 stock split. At December 31, 2006, there were 286,000 additional shares available for grant under the plan. There were no nonvested shares outstanding at December 31, 2006.

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

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| Options                          | Shares <sup>1</sup> | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|---------------------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2006   | 172,500             | \$19.90                         |   |                           |
| Granted                          | ---                 |                                 |   |                           |
| Exercised                        | (10,710)            | \$11.44                         |   |                           |
| Forfeited or expired             | ---                 |                                 |   |                           |
| Outstanding at December 31, 2006 | 161,790             | \$20.46                         | 7.1   | \$58                      |
|                                  | =====               | =====                           | ===   | ===                       |
| Exercisable at December 31, 2006 | 161,790             | \$20.46                         | 7.1   | \$58                      |
|                                  | =====               | =====                           | ===   | ===                       |

The weighted-average fair value of options granted were \$4.10 and \$5.81 in 2005 and 2004, respectively. The intrinsic value of shares exercised were \$136, \$160 and \$291 for 2006, 2005 and 2004, respectively. At December 31, 2006 there were no nonvested shares.

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

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

Note 10: Income Taxes

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

|                          | Years ended December 31, |         |         |
|--------------------------|--------------------------|---------|---------|
|                          | 2006                     | 2005    | 2004    |
| Current                  | \$3,539                  | \$3,855 | \$3,772 |
| Deferred                 | 249                      | 69      | (18)    |
| Total income tax expense | \$3,788                  | \$3,924 | \$3,754 |
|                          | =====                    | =====   | =====   |

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

|  | Years ended December 31, |         |          |
|--|--------------------------|---------|----------|
|  | 2006                     | 2005    | 2004     |
| Computed "expected" income tax expense | \$5,747                  | \$5,722 | \$ 5,594 |

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|                                |         |         |         |
|--------------------------------|---------|---------|---------|
| Tax-exempt interest income     | (1,919) | (1,947) | (1,943) |
| Nondeductible interest expense | 277     | 196     | 149     |
| Other, net                     | (317)   | (47)    | (46)    |
| Reported income tax expense    | \$3,788 | \$3,924 | \$3,754 |

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

|  | December 31, |         |
|--|--------------|---------|
|  | 2006         | 2005    |
| Deferred tax assets:                                   |              |         |
| Allowance for loan losses and unearned fee income      | \$1,804      | \$1,905 |
| Valuation allowance on other real estate owned         | 33           | 29      |
| Deferred compensation and other liabilities            | 1,579        | 499     |
| Deposit intangibles and goodwill                       | ---          | 2       |
| Net unrealized losses on securities available for sale | 360          | 446     |
|  | \$3,776      | \$2,881 |
| Deferred tax liabilities:                              |              |         |
| Fixed assets   | \$(170)      | \$(207) |
| Discount accretion on securities                       | (117)        | (105)   |
| Deposit intangibles and goodwill                       | (268)        | ---     |
| Other  | (142)        | (128)   |
| Net deferred tax asset                                 | 3,079        | 2,441   |

The Company has determined that a valuation allowance for the gross deferred tax assets is not necessary at December 31, 2006 and 2005 due to the fact that the realization of the entire gross deferred tax assets can be supported by the amount of taxes paid during the carryback period available under current tax laws.

### Note 11: Restrictions on Dividends

Bankshares' principal source of funds for dividend payments is dividends received from its subsidiary banks. For the years ended December 31, 2006, 2005, and 2004, dividends received from subsidiary banks were \$5,859, \$5,795 and \$4,504, respectively.

Substantially all of Bankshares' retained earnings are undistributed earnings of its banking subsidiary, which are restricted by various regulations administered by federal bank regulatory agencies. Bank regulatory agencies restrict, without prior approval, the total dividend payments of a bank in any calendar year to the bank's retained net income of that year to date, as defined, combined with its retained net income of the preceding two years, less any required transfers to surplus. At December 31, 2006, retained net income, which was free of such restriction, amounted to approximately \$21,620.

### Note 12: Minimum Regulatory Capital Requirement

The Company (on a consolidated basis) and its subsidiary bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

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Quantitative measures established by regulation to ensure capital adequacy require the Company and the bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2006 and 2005, that the Company and the bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2006, the most recent notifications from the appropriate regulatory authorities categorized the bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since these notifications that management believes have changed the banks' category. The Company's and the bank's actual capital amounts and ratios as of December 31, 2006 and 2005 are also presented in the following tables.

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|  | Actual   |       | Minimum Capital Requirement |       |
|--|----------|-------|-----------------------------|-------|
|  | Amount   | Ratio | Amount                      | Ratio |
| December 31, 2006                        |          |       |                             |       |
| Total capital (to risk weighted assets)  |          |       |                             |       |
| Bankshares consolidated                  | \$89,081 | 15.0% | \$47,399                    |       |
| NBB                                      | 85,061   | 14.5% | 47,072                      |       |
| Tier 1 capital (to risk weighted assets) |          |       |                             |       |
| Bankshares consolidated                  | \$83,873 | 14.2% | \$23,700                    |       |
| NBB                                      | 79,904   | 13.6% | 23,836                      |       |
| Tier 1 capital (to average assets)       |          |       |                             |       |
| Bankshares consolidated                  | \$83,873 | 10.0% | \$33,523                    |       |
| NBB                                      | 79,904   | 9.6%  | 33,425                      |       |

|   | Actual |       | Minimum Capital Requirement |       |
|---|--------|-------|-----------------------------|-------|
|   | Amount | Ratio | Amount                      | Ratio |
| December 31, 2005                       |        |       |                             |       |
| Total capital (to risk weighted assets) |        |       |                             |       |



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|  |          |       |          |
|--|----------|-------|----------|
| Bankshares consolidated                  | \$81,745 | 14.1% | \$46,446 |
| NBB                                      | 44,929   | 12.4% | 28,955   |
| BTC                                      | 32,181   | 15.1% | 17,102   |
| Tier 1 capital (to risk weighted assets) |          |       |          |
| Bankshares consolidated                  | \$76,233 | 13.1% | \$23,223 |
| NBB                                      | 41,944   | 11.6% | 14,477   |
| BTC                                      | 29,717   | 13.9% | 8,551    |
| Tier 1 capital (to average assets)       |          |       |          |
| Bankshares consolidated                  | \$76,233 | 9.3%  | \$32,634 |
| NBB                                      | 41,944   | 8.8%  | 18,984   |
| BTC                                      | 29,717   | 8.9%  | 13,399   |

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### Note 13: Condensed Financial Statements of Parent Company

Financial information pertaining only to Bankshares (Parent) is as follows:

| Condensed Balance Sheets |   | December 31,<br>2006 |
|--------------------------|---|----------------------|
|                          |   | -----                |
| Assets                   | Cash due from subsidiaries                    | \$ 65                |
|                          | Securities available for sale                 | 2,998                |
|                          | Investments in subsidiaries, at equity        | 93,462               |
|                          | Refundable income taxes due from subsidiaries | 160                  |
|                          | Other assets                                  | 526                  |
|                          |   | ---                  |
|                          | Total assets                                  | \$97,211             |
|                          |   | =====                |
| Liabilities              | Other liabilities                             | \$456                |
| And                      | Stockholders' equity                          | 96,755               |
|                          |   | -----                |
| Stockholders' Equity     | Total liabilities and stockholders' equity    | \$97,211             |
|                          |   | =====                |

| Condensed Statements of Income |                                     | Years End<br>2006 |
|--------------------------------|-------------------------------------|-------------------|
|                                |                                     | -----             |
| Income                         | Dividends from Subsidiaries         | \$5,859           |
|                                | Interest on securities - taxable    | 24                |
|                                | Interest on securities - nontaxable | 84                |
|                                | Other income                        | 1,033             |
|                                | Securities gains                    | 2                 |
|                                |                                     | -                 |

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|          |   |          |
|----------|---|----------|
|          |   | 7,002    |
| Expenses | Other expenses  | 1,605    |
|          |   | -----    |
|          | Income before income tax benefit and equity in undistributed net income of subsidiaries | 5,397    |
|          | Applicable income tax benefit   | 187      |
|          |   | ---      |
|          | Income before equity in undistributed net income of subsidiaries                        | 5,584    |
|          | Equity in undistributed net income of subsidiaries                                      | 7,048    |
|          |   | -----    |
|          | Net income  | \$12,632 |
|          |   | =====    |

Condensed Statements of Cash Flows

|                                      |   | Years en |
|--------------------------------------|---|----------|
|                                      |   | 2006     |
|                                      |   | -----    |
| Cash Flows From Operating Expenses   | Net income  | \$12,632 |
|                                      | Adjustments to reconcile net income to net cash provided by operating activities: |          |
|                                      | Equity in undistributed net income of subsidiaries                                | (7,048)  |
|                                      | Amortization of premiums and accretion of discounts, net                          | 27       |
|                                      | Depreciation expense  | 9        |
|                                      | Securities (gains)  | (2)      |
|                                      | Net change in refundable income taxes due from subsidiaries                       | (62)     |
|                                      | Net change in other assets  | ---      |
|                                      | Net change in other liabilities   | (87)     |
|                                      | Net cash provided by operating activities   | 5,469    |
| Cash Flows from Investing Activities | Purchases of securities available for sale  | (1,044)  |
|                                      | Proceeds from sales of securities available for sale                              | ---      |
|                                      | Maturities and calls of securities available for sale                             | 1,751    |
|                                      | Net cash (used in) investing activities   | 707      |
| Cash Flows from Financing Activities | Cash dividends paid   | (5,108)  |
|                                      | Common stock repurchase   | (1,183)  |
|                                      | Exercise of stock options   | 122      |
|                                      | Net cash used in financing activities   | (6,169)  |
|                                      | Net change in cash  | 7        |
|                                      | Cash due from subsidiaries at beginning of year                                   | 58       |
|                                      | Cash due from subsidiaries at end of year   | \$65     |

Note 14: Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby

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

The Company's exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support the following financial instruments with credit risk.

At December 31, 2006, and 2005, financial instruments were outstanding whose contract amounts represent credit risk:

|   | December 31, |      |
|---|--------------|------|
|   | 2006         |      |
|   |              |      |
| Financial instruments whose contract amounts represent credit risk: |              |      |
| Commitments to extend credit  | \$ 125,447   | \$ 1 |
| Standby letters of credit   | 8,391        |      |
| Mortgage loans sold with potential recourse                         | 19,022       |      |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

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

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

The Company originates mortgage loans for sale to secondary market investors subject to contractually specified and limited recourse provisions. In 2006, the Company originated \$19,830 and sold \$19,022 to investors, compared to \$16,912 originated and \$17,915 sold in 2005. Every contract with each investor contains certain recourse language. In general, the Company may be required to repurchase a previously sold mortgage loan if there is major noncompliance with defined loan origination or documentation standards, including fraud, negligence or material misstatement in the loan documents. Repurchase may also be required if necessary governmental loan guarantees are canceled or never issued, or if an investor is forced to buy back a loan after it has been resold as a part of a loan pool. In addition, the Company may have an obligation to repurchase a loan if the mortgagor has defaulted early in the loan term. This potential default period is approximately twelve months after sale of a loan to the investor.

At December 31, 2006, the Company had locked-rate commitments to originate mortgage loans amounting to approximately \$2,699 and loans held for sale of \$808. The Company has entered into commitments, on a best-effort basis, to sell loans of approximately \$3,507. Risks arise from the possible inability of

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counterparties to meet the terms of their contracts. The Company does not expect any counterparty to fail to meet its obligations.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2006 that exceeded the insurance limits of the Federal Deposit Insurance Corporation was \$20,531.

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### Note 15: Concentrations of Credit Risk

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

At December 31, 2006 and 2005, approximately \$258,212 and \$255,230, respectively, of the loan portfolio was concentrated in commercial real estate. This represents approximately 52% of the loan portfolio at December 31, 2006 and 2005. Included in commercial loans at December 31, 2006 and 2005 was approximately \$133,049 and \$121,265, respectively, in loans for college housing and professional office buildings. This represents approximately 27% and 25% of the loan portfolio at December 31, 2006 and 2005, respectively. Loans secured by residential real estate were approximately \$151,106 and \$147,955 at December 31, 2006 and 2005, respectively. This represents approximately 30% of the loan portfolio at December 31, 2006 and 2005, respectively. Loans secured by automobiles were approximately \$16,282 and \$17,309 at December 31, 2006 and 2005, respectively. This represents approximately 3% and 4% of the loan portfolio at December 31, 2006 and December 31, 2005.

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

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

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

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to

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the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits.

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

The carrying amounts approximate fair value.

### Securities

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

### Loans Held for Sale

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

### Loans

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 judgmentally determined using available market information and specific borrower information.

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### Deposits

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

### Accrued Interest

The carrying amounts of accrued interest approximate fair value.

### Other Borrowed Funds

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

### Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are not deemed significant at December 31, 2006 and 2005, and, as such, the related fair values have not been estimated.

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

|                               | December 31,    |                      |                 |
|-------------------------------|-----------------|----------------------|-----------------|
|                               | 2006            |                      |                 |
|                               | Carrying Amount | Estimated Fair Value | Carrying Amount |
| <b>Financial assets:</b>      |                 |                      |                 |
| Cash and due from banks       | \$ 15,283       | \$ 15,283            | \$ 20,11        |
| Interest-bearing deposits     | 19,617          | 19,617               | 10,27           |
| Securities                    | 285,489         | 285,296              | 272,54          |
| Mortgage loans held for sale  | 808             | 808                  | --              |
| Loans, net                    | 495,486         | 477,859              | 487,16          |
| Accrued interest receivable   | 5,682           | 5,682                | 5,14            |
| <b>Financial liabilities:</b> |                 |                      |                 |
| Deposits                      | \$ 764,692      | \$ 755,564           | \$ 745,64       |
| Other borrowed funds          | 73              | 73                   | 35              |
| Accrued interest payable      | 863             | 863                  | 72              |

Note 17: Selected Quarterly Data (Unaudited)

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2006 and 2005:

|                                    | 2006          |                |               |
|------------------------------------|---------------|----------------|---------------|
|                                    | First Quarter | Second Quarter | Third Quarter |
| <b>Income Statement Data:</b>      |               |                |               |
| Interest income                    | \$ 11,583     | \$ 11,849      | \$ 12,042     |
| Interest expense                   | 4,238         | 4,374          | 4,691         |
| Net interest income                | 7,345         | 7,475          | 7,351         |
| Provision for loan losses          | 17            | 7              | 16            |
| Noninterest income                 | 2,059         | 2,212          | 2,232         |
| Noninterest expense                | 5,499         | 5,401          | 5,396         |
| Income taxes                       | 885           | 1,052          | 970           |
| Net income                         | \$ 3,003      | \$ 3,227       | \$ 3,201      |
| <b>Per Share Data:</b>             |               |                |               |
| Basic net income per share         | \$ 0.43       | \$ 0.46        | \$ 0.46       |
| Fully diluted net income per share | 0.43          | 0.46           | 0.46          |
| Cash dividends per share           | ---           | 0.36           | ---           |
| Book value per share               | 13.44         | 13.31          | 14.00         |

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|                                    | First<br>Quarter | Second<br>Quarter | Third<br>Quarter |
|------------------------------------|------------------|-------------------|------------------|
| Income Statement Data:             |                  |                   |                  |
| Interest income                    | \$ 11,035        | \$ 11,268         | \$ 11,483        |
| Interest expense                   | 3,043            | 3,226             | 3,816            |
|                                    | -----            | -----             | -----            |
| Net interest income                | 7,992            | 8,042             | 7,667            |
| Provision for loan losses          | 190              | 198               | 169              |
| Noninterest income                 | 1,768            | 1,927             | 1,892            |
| Noninterest expense                | 5,689            | 5,591             | 5,379            |
| Income taxes                       | 888              | 1,028             | 957              |
| Net income                         | \$ 2,993         | \$ 3,152          | \$ 3,054         |
| Per Share Data:                    |                  |                   |                  |
| Basic net income per share         | \$ 0.425         | \$ 0.45           | \$ 0.435         |
| Fully diluted net income per share | 0.425            | 0.445             | 0.430            |
| Cash dividends per share           | ---              | 0.35              | ---              |
| Book value per share               | 12.61            | 12.80             | 13.20            |

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[GRAPHIC OMITTED] [YHB Letterhead]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of National Bankshares, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that National Bankshares, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). National Bankshares, Inc. and subsidiaries' management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material

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respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of National Bankshares, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that National Bankshares, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, National Bankshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As noted in Note 8 to the consolidated financial statements, National Bankshares, Inc. and subsidiaries changed their method of accounting for their defined benefit pension plan to adopt 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)."

[GRAPHIC OMITTED][YHB Signature]

Winchester, Virginia  
February 23, 2007



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

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

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

Disclosure controls and procedures are our controls and procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

Management's Report on Internal Control Over Financial Reporting.

To the Stockholders  
National Bankshares, Inc.

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

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

In order to ensure that the Company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2006. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management believes the Company maintained effective internal control over financial reporting as of December 31, 2006.

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

Yount, Hyde & Barbour, P.C., independent auditors of the Company's financial statements, has attested to management's assertion with respect to the effectiveness of the Company's internal control over financial reporting as of December 31, 2006.

/s/JAMES G. RAKES

-----  
Chairman, President and  
Chief Executive Officer

/s/J. ROBERT BUCHANAN

-----  
Treasurer and  
Chief Financial Officer

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### Item 9B. Other Information

Not Applicable

### Part III

### Item 10. Directors, Executive Officers and Corporate Governance

Information with respect to the directors of Bankshares is set out under the caption "Election of Directors" on pages 2 through 4 of Bankshares' Proxy Statement dated March 14, 2007 which information is incorporated herein by reference.

The Board of Directors of Bankshares has a standing audit committee made up entirely of independent directors, as that term is defined in the NASDAQ Stock Market Rules. In 2006, Dr. J. R. Stewart chaired the Audit Committee and its members were Mr. L. J. Ball, Mr. J. H. Harry and Dr. J. M. Lewis. Each member of the Audit Committee has extensive business experience; however, the Committee has identified Dr. Lewis as its financial expert, since he has a professional background which involves financial oversight responsibilities. Dr. Lewis currently oversees the preparation of financial statements in his role as President of New River Community College. He previously served as the College's Chief Financial Officer. The Audit Committee's Charter is available on the Company's web site at [www.nationalbankshares.com](http://www.nationalbankshares.com).

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

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

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| Name               | Age | Offices and Positions Held   |
|--------------------|-----|--|
| James G. Rakes     | 62  | Chairman, President and Chief Executive Officer, National Bankshares, Inc.; President and Chief Executive Officer of The National Bank of Blacksburg since 1983 and Chairman since 2005. Chairman, President and Treasurer of National Bankshares Financial Services, Inc. since 2001.   |
| J. Robert Buchanan | 55  | Treasurer, National Bankshares, Inc.; Executive Vice President/Chief Financial Officer of The National Bank of Blacksburg since 2006; prior thereto Executive Vice President/Chief Operating Officer and Secretary of Bank of Tazewell County since 2003; prior thereto Cashier and Senior Vice President/Chief Financial Officer of The National Bank of Blacksburg since 1998. |
| Marilyn B. Buhyoff | 58  | Secretary & Counsel, National Bankshares, Inc.; Counsel of The National Bank of Blacksburg since 1989, Trust Officer since 2004, and prior thereto Senior Vice President/ Administration, since 1992. Secretary of National Bankshares Financial Services, Inc. since 2001, and Executive Vice President since 2004.   |
| F. Brad Denardo    | 54  | Corporate Officer, National Bankshares, Inc.; Executive Vice President/Chief Operating Officer of The National Bank of Blacksburg since 2002; prior thereto Executive Vice President/Loans of The National Bank of Blacksburg since 1989.  |

Item 11. Executive Compensation

The information set forth under "Executive Compensation" on pages 8 through 13 of Bankshares' Proxy Statement dated March 14, 2007 is incorporated herein by reference.

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

The information contained under "Stock Ownership of Directors and Executive Officers" on pages 1 and 2 of Bankshares' Proxy Statement dated March 14, 2007 for the Annual Meeting of Stockholders to be held April 10, 2007 is incorporated herein by reference.

The following table summarizes information concerning National Bankshares equity compensation plans at December 31, 2006:

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| Plan Category  | Number of Shares to be Issued upon Exercise of Outstanding Options and Warrants | Weighted Average Exercise Price of Outstanding Options and Warrants |
|--|---|---|
| Equity compensation plans approved by stockholders-1999 Stock Incentive Plan | 161,790   | \$ 20.4   |
| Equity compensation plans not approved by stockholders                       | ---   | --  |
| <b>Total</b>   | <b>161,790</b>  | <b>\$ 20.4</b>  |

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information contained under "Director Independence and Certain Transactions With Officers and Directors" on page 5 of Bankshares' Proxy Statement dated March 14, 2007 is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The following fees were paid to Yount, Hyde & Barbour, P.C., Certified Public Accountants, for services provided to Bankshares for the years ended December 31, 2006 and 2005. The Audit Committee determined that the provision of non-audit services by Yount, Hyde & Barbour P.C. did not compromise the firm's ability to maintain its independence.

|                    | 2006             |             | 2005             |             |
|--------------------|------------------|-------------|------------------|-------------|
|                    | Fees             | Percentage  | Fees             | Percentage  |
| Audit fees         | \$76,000         | 71%         | \$89,400         | 78%         |
| Audit-related fees | 26,000           | 24%         | 18,348           | 16%         |
| Tax fees           | 5,500            | 5%          | 7,350            | 6%          |
|                    | <b>\$107,500</b> | <b>100%</b> | <b>\$115,098</b> | <b>100%</b> |

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

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

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

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

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### Part IV

#### Item 15. Exhibits, Financial Statement Schedules

##### (a) (1) Financial Statements

The following consolidated financial statements of National Bankshares, Inc. are included in Item 8:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets - As of December 31, 2006 and 2005  
Consolidated Statements of Income - Years ended December 31, 2006, 2005 and 2004  
Consolidated Statements of Changes in Stockholders Equity - Years ended December 31, 2006, 2005 and 2004  
Consolidated Statements of Cash Flows - Years ended December 31, 2006, 2005 and 2004  
Notes to Consolidated Financial Statements

##### (a) (2) Financial Statement Schedules

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

##### (a) (3) Exhibits

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

|              |  |  |
|--------------|--|--|
| 3(i)         | Articles of Incorporation, as amended, of National Bankshares, Inc.  | (incorporate Exhibit 3(a) Form 10K for December 31,  |
| 3(i)         | Articles of Amendment to Articles of Incorporation of National Bankshares, Inc., dated April 8, 2003.                                    | (incorporate Exhibit 3(i) Form 10K for December 31,  |
| 3(i)         | Amended and Restated Articles of Incorporation of National Bankshares, Inc.  | (incorporate Exhibit 3.1 on March 16,                |
| 4(i)         | Specimen copy of certificate for National Bankshares, Inc. common stock, \$2.50 par value  | (incorporate Exhibit 4(a) Form 10K for December 31,  |
| 4(i)         | Article Four of the Articles of Incorporation of National Bankshares, Inc. included in Exhibit No. 3(a)                                  | (incorporate Exhibit 4(b) Form 10K for December 31,  |
| 10(ii) (B)   | Computer software license agreement dated June 18, 1990, by and between Information Technology, Inc. and The National Bank of Blacksburg | (incorporate Exhibit 10(e) Form 10K for December 31, |
| *10(iii) (A) | National Bankshares, Inc. 1999 Stock Option Plan   | (incorporate Exhibit 4.3 Registration                |

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|               |  |   |
|---------------|--|---|
|               |  | Commission o                              |
| *10 (iii) (A) | Employment Agreement dated January 2002 between National Bankshares, Inc. and James G. Rakes   | (incorporated Exhibit 10 (i) the period e |
| *10 (iii) (A) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg  | (incorporate Exhibit 10 (i) the period e  |
| *10 (iii) (A) | Change in Control Agreement dated January 5, 2003, between National Bankshares, Inc. and Marilyn B. Buhyoff  | (incorporate Exhibit 10 (i) the period e  |
| *10 (iii) (A) | Change in Control Agreement dated January 8, 2003, between National Bankshares, Inc. and F. Brad Denardo   | (incorporate Exhibit 10 (i) the period e  |
| +21 (i)       | Subsidiaries of National Bankshares, Inc.  | Page 63                                   |
| +23           | Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8. | Page 64                                   |
| 31 (i)        | Section 906 Certification of Chief Executive Officer   | Page 58                                   |
| 31 (ii)       | Section 906 Certification of Chief Financial Officer   | Page 59                                   |
| 32 (i)        | 18 U.S.C. Section 1350 Certification of Chief Executive Officer  | Page 61                                   |
| 32 (ii)       | 18 U.S.C. Section 1350 Certification of Chief Financial Officer  | Page 61                                   |

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

Signatures

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

NATIONAL BANKSHARES, INC.

/s/ JAMES G. RAKES

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

/s/ J. ROBERT BUCHANAN

-----  
J. Robert Buchanan  
Treasurer  
(Principal Financial Officer)

Date: March 14, 2007

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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 annual report on Form 10-K of National Bankshares, Inc.;

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

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

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

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

(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

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

Date: March 14, 2007

/s/ JAMES G. RAKES

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

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Exhibit 31(ii)

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

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

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

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

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



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report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

Date: March 14, 2007

/s/ J. ROBERT BUCHANAN

-----  
 J. Robert Buchanan  
 Treasurer  
 (Principal Financial Officer)

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

| Name               | Date       | Title                                   |
|--------------------|------------|---|
| -----              | -----      | -----                                   |
| /s/L. J. BALL      | 03/14/2007 | Director                                |
| -----              | -----      |   |
| L. J. Ball         |            |   |
| /s/ J. H. HARRY    | 03/14/2007 | Director                                |
| -----              | -----      |   |
| J. H. Harry        |            |   |
| /s/ J. M. LEWIS    | 03/14/2007 | Director                                |
| -----              | -----      |   |
| J. M. Lewis        |            |   |
| /s/ M. G. MILLER   | 03/14/2007 | Director                                |
| -----              | -----      |   |
| M. G. Miller       |            |   |
| /s/ W. A. PEERY    | 03/14/2007 | Director                                |
| -----              | -----      |   |
| W. A. Peery        |            |   |
| /s/ J. G. RAKES    | 03/14/2007 | Chairman of the Board                   |
| -----              | -----      | President and Chief Executive Officer - |
| J. G. Rakes        |            | National Bankshares, Inc.               |
|                    |            |   |
| /s/ G. P. REYNOLDS | 03/14/2007 | Director                                |
| -----              | -----      |   |
| G. P. Reynolds     |            |   |
|                    |            |   |
| /s/ J. M. SHULER   | 03/14/2007 | Director                                |

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-----  
J. M. Shuler

/s/ J. R. STEWART

03/14/2007

Director

-----  
J. R. Stewart

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Exhibit 32(i)

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

In connection with the Form 10-K of National Bankshares, Inc. for the year ended December 31, 2006, I, James G. Rakes, Chairman, President and Chief Executive Officer of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief that:

(1) such Form 10-K for the year ended December 31, 2006, fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and

(2) the information contained in such Form 10-K for the year ended December 31, 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 EXECUTIVE OFFICER  
PURSUANT TO U.S.C. SECTION 1350

In connection with the Form 10-K of National Bankshares, Inc. for the year ended December 31, 2006, I, J. Robert Buchanan, Treasurer of National Bankshares, Inc. hereby certify pursuant to 18 U. S. C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief that:

(1) such Form 10-K for the year ended December 31, 2006, fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and

(2) the information contained in such Form 10-K for the year ended December 31, 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

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Treasurer  
(Principal Financial Officer)

Index of Exhibits

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

|        |  |         |
|--------|--|---------|
| 21(i)  | Subsidiaries of National Bankshares, Inc.  | Page 63 |
| 23     | Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8. | Page 64 |
| 31(i)  | Section 906 Certification of Chief Executive Officer   | Page 58 |
| 31(ii) | Section 906 Certification of Chief Financial Officer   | Page 59 |
| 32(i)  | 18 U.S.C. Section 1350 Certification of Chief Executive Officer  | Page 61 |
| 32(ii) | 18 U.S.C. Section 1350 Certification of Chief Financial Officer  | Page 61 |

Exhibit No. 21(i)

SUBSIDIARIES  
OF  
NATIONAL BANKSHARES, INC.

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National Bankshares, Inc.  
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The National Bank  
of Blacksburg  
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National Bankshares  
Financial Services, Inc.  
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