

NATIONAL BANKSHARES INC
Form 10-Q
May 09, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

X Quarterly Report Pursuant to Section 13 or 15(d) Of the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2008.

o Transition Report Pursuant To Section 13 OR 15(d) Or The Securities Exchange Act Of 1934

For the transition period from _____ to _____.

Commission file number 0-15204

NATIONAL BANKSHARES, INC.

(Exact name of Registrant as specified in its Charter)

Virginia
(State of incorporation)

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

101 Hubbard Street

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

| <u>Class</u> | <u>Outstanding at April 30, 2008</u> |
|--------------------------------|--------------------------------------|
| Common Stock, \$1.25 Par Value | 6,922,974 |

(This report contains 27 pages)

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q

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Part I**Financial Information****Item 1. Financial Statements**

National Bankshares, Inc. and Subsidiaries

Consolidated Balance Sheets

| (\$ in thousands, except share data) | (Unaudited) March 31, 2008 | December 31, 2007 |
|--|----------------------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 18,742 | \$ 16,324 |
| Interest-bearing deposits | 43,876 | 29,687 |
| Securities available for sale, at fair value | 161,302 | 158,594 |
| Securities held to maturity (fair value approximates \$118,287 at March 31, 2008 and \$115,463 at December 31, 2007) | 116,190 | 114,749 |
| Mortgage loans held for sale | 469 | 220 |
| Loans: | | |
| Real estate construction loans | 52,287 | 46,697 |
| Real estate mortgage loans | 148,656 | 145,542 |
| Commercial and industrial loans | 219,346 | 216,830 |
| Loans to individuals | 108,395 | 115,704 |
| Total loans | 528,684 | 524,773 |
| Less unearned income and deferred fees | (1,113) | (1,119) |
| Loans, net of unearned income and deferred fees | 527,571 | 523,654 |
| Less: allowance for loan losses | (5,228) | (5,219) |
| Loans, net | 522,343 | 518,435 |
| Bank premises and equipment, net | 11,841 | 12,016 |
| Accrued interest receivable | 5,703 | 5,711 |
| Other real estate owned, net | 270 | 263 |
| Intangible assets and goodwill, net | 14,554 | 14,838 |
| Other assets | 16,431 | 16,810 |
| Total assets | \$ 911,721 | \$ 887,647 |
| Liabilities and Stockholders' Equity | | |
| Noninterest-bearing demand deposits | \$ 118,554 | \$ 113,361 |
| Interest-bearing demand deposits | 247,411 | 237,772 |
| Savings deposits | 45,010 | 44,349 |
| Time deposits | 384,110 | 380,857 |

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| | | |
|--------------------------|----------------|---------|
| Total deposits | 795,085 | 776,339 |
| Other borrowed funds | 61 | 64 |
| Accrued interest payable | 800 | 792 |
| Other liabilities | 6,818 | 5,652 |
| Total liabilities | 802,764 | 782,847 |

continued

Stockholders' Equity

Preferred stock of no par value.

Authorized 5,000,000 shares; none issued and outstanding

Common stock of \$1.25 par value.

Authorized 10,000,000 shares; issued and outstanding 6,928,574 shares in 2008 and 6,952,274 in 2007

8,661

8,690

Retained earnings

100,518

97,810

Accumulated other comprehensive (loss), net

(222

)

(1,700

)

Total stockholders' equity

108,957

104,800

Total liabilities and stockholders' equity

\$ 911,721

\$ 887,647

See accompanying notes to the consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Three Months Ended March 31, 2008 and 2007

(Unaudited)

| (\$ in thousands, except share and per share data) | March 31, 2008 | March 31, 2007 |
|---|-------------------|-------------------|
| Interest income | | |
| Interest and fees on loans | \$ 9,353 | \$ 9,037 |
| Interest on interest-bearing deposits | 261 | 274 |
| Interest on securities – taxable | 1,710 | 1,896 |
| Interest on securities – nontaxable | 1,387 | 1,323 |
| Total interest income | 12,711 | 12,530 |
| Interest expense | | |
| Interest on time deposits \$100,000 or more | 1,664 | 1,583 |
| Interest on other deposits | 3,742 | 3,832 |
| Interest on borrowed funds | 1 | 1 |
| Total interest expense | 5,407 | 5,416 |
| Net interest income | 7,304 | 7,114 |
| Provision for loan losses | 100 | (3 |
| Net interest income after provision for loan losses | 7,204 | 7,117 |
| Noninterest income | | |
| Service charges on deposit accounts | 768 | 810 |
| Other service charges and fees | 84 | 83 |
| Credit card fees | 637 | 598 |
| Trust income | 303 | 373 |
| Other income | 221 | 264 |
| Realized securities gains, net | 283 | 51 |
| Total noninterest income | 2,296 | 2,179 |
| Noninterest expense | | |
| Salaries and employee benefits | 2,857 | 2,841 |
| Occupancy, furniture and fixtures | 456 | 485 |
| Data processing and ATM | 349 | 258 |
| Credit card processing | 460 | 447 |
| Intangibles amortization | 284 | 284 |
| Net costs of other real estate owned | 14 | 58 |
| Other operating expenses | 1,037 | 884 |

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| | | |
|----------------------------------|-----------------|-----------------|
| Total noninterest expense | 5,457 | 5,257 |
| Income before income tax expense | 4,043 | 4,039 |
| Income tax expense | 862 | 923 |
| Net income | \$ 3,181 | \$ 3,116 |

continued

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| | | |
|-----------------------------------|-----------|-----------|
| Net income per share - basic | \$ 0.46 | \$ 0.45 |
| - diluted | \$ 0.46 | \$ 0.45 |
| Weighted average number of common | | |
| shares outstanding - basic | 6,937,933 | 6,979,094 |
| - diluted | 6,947,278 | 7,000,683 |
| Dividends declared per share | \$ --- | \$ --- |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

Three Months Ended March 31, 2008 and 2007

(Unaudited)

| (\$ in thousands, except per share data) | Common Stock | Retained Earnings | Accumulated Other Comprehensive (Loss) | Comprehensive Income | Total |
|---|-----------------|-------------------|--|----------------------|-------------------|
| Balances at December 31, 2006 | \$ 8,725 | \$ 91,123 | \$ (3,093) | | \$ 96,755 |
| Net income | --- | 3,116 | --- | \$ 3,116 | 3,116 |
| Exercise of stock options | 8 | 52 | --- | --- | 60 |
| Other comprehensive income, net of tax: | | | | | |
| Unrealized gain on securities available for sale, net of income tax \$22 | --- | --- | --- | 40 | --- |
| Reclass adjustment, net of tax \$(18) | --- | --- | --- | (33) | --- |
| Other comprehensive income, net of tax \$4 | --- | --- | 7 | 7 | 7 |
| Comprehensive income | --- | --- | --- | \$ 3,123 | --- |
| Stock repurchase | (6) | (109) | --- | | (115) |
| Balances at March 31, 2007 | \$ 8,727 | \$ 94,182 | \$ (3,086) | | \$ 99,823 |
| Balances at December 31, 2007 | \$ 8,690 | \$ 97,810 | \$ (1,700) | | \$ 104,800 |
| Net income | --- | 3,181 | --- | \$ 3,181 | 3,181 |
| Exercise of stock options | --- | --- | --- | --- | --- |
| Other comprehensive income, net of tax: | | | | | |
| Unrealized gain on securities available for sale, net of income tax \$886 | --- | --- | --- | 1,645 | --- |
| Reclass adjustment, net of income tax \$(92) | --- | --- | --- | (170) | --- |
| Other comprehensive income, net of tax \$794 | --- | --- | 1,475 | 1,475 | 1,475 |
| Comprehensive income | --- | --- | --- | \$ 4,656 | --- |
| Effect of changing pension plan measurement date pursuant to SFAS No. 158 | | (45) | 3 | | (42) |
| Stock repurchase | (29) | (428) | --- | | (457) |
| Balances at March 31, 2008 | \$ 8,661 | \$ 100,518 | \$ (222) | | \$ 108,957 |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Three Months Ended March 31, 2008 and 2007

(Unaudited)

| (\$ in thousands) | March 31, 2008 | March 31, 2007 | |
|--|-------------------|-------------------|--------------|
| Cash flows from operating activities | | | |
| Net income | \$ 3,181 | \$ 3,116 | |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Provision for loan losses | 100 | (3 |) |
| Depreciation of bank premises and equipment | 249 | 247 | |
| Amortization of intangibles | 284 | 284 | |
| Amortization of premiums and accretion of discount, net | 63 | 55 | |
| Gains on sales and calls of securities available for sale, net | (262 |) | (51) |
| Gains on calls of securities held to maturity | (21 |) | --- |
| Losses and writedowns on other real estate owned | --- | 37 | |
| Net change in: | | | |
| Mortgage loans held for sale | (249 |) | (495) |
| Accrued interest receivable | 8 | (224 |) |
| Other assets | (394 |) | (191) |
| Accrued interest payable | 8 | (21 |) |
| Other liabilities | 1,103 | 1,095 | |
| Net cash provided by operating activities | \$ 4,070 | \$ 3,849 | |
| Cash flows from investing activities | | | |
| Net change interest-bearing deposits | \$ (14,189 |) | \$ (9,884) |
| Proceeds from calls, principal payments, sales and maturities of securities available for sale | 10,150 | 7,799 | |
| Proceeds from calls, principal payments and maturities of securities held to maturity | 17,031 | 130 | |
| Purchases of securities available for sale | (10,370 |) | (4,198) |
| Purchases of securities held to maturity | (18,471 |) | (6,240) |
| Purchases of loan participations | (117 |) | --- |
| Collections of loan participations | 61 | 281 | |
| Loan originations and principal collections, net | (4,028 |) | (3,076) |
| Proceeds from disposal of other real estate owned | 8 | 230 | |
| Recoveries on loans charged off | 61 | 27 | |
| Purchase of bank premises and equipment | (74 |) | (90) |
| Net cash used in investing activities | \$ (19,938 |) | \$ (15,021) |
| Cash flows from financing activities | | | |

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| | | | | | |
|------------------------------------|----|---------------|----|-----------|---|
| Net change in other deposits | \$ | 15,493 | \$ | 13,147 | |
| Net change in time deposits | | 3,253 | | (3,575) |) |
| Net change in other borrowed funds | | (3 |) | (2 |) |
| Stock options exercised | | --- | | 60 | |

continued

| | | | | |
|--|------|---------------|------|---------|
| Common stock repurchased | (457 |) | (115 |) |
| Net cash provided by financing activities | \$ | 18,286 | \$ | 9,515 |
| Net change in cash and due from banks | \$ | 2,418 | \$ | (1,657) |
| Cash and due from banks at beginning of period | | 16,324 | | 15,283 |
| Cash and due from banks at end of period | \$ | 18,742 | \$ | 13,626 |

Supplemental disclosure of cash flow information

| | | | | |
|---|----|--------------|----|-------|
| Cash paid for interest | \$ | 5,399 | \$ | 5,437 |
| Cash paid for income taxes | \$ | 105 | \$ | 44 |
| Loans charged to the allowance for loan losses | \$ | 152 | \$ | 136 |
| Loans transferred to other real estate owned | \$ | 15 | \$ | 128 |
| Unrealized gains on securities available for sale | \$ | 2,269 | \$ | 11 |
| Effect of changing pension plan measurement data | \$ | 63 | | --- |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

March 31, 2008

(Unaudited)

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

Note (1)

The consolidated financial statements of National Bankshares, Inc. (NBI) and its wholly-owned subsidiaries, The National Bank of Blacksburg (NBB) and National Bankshares Financial Services, Inc. (NBFS), (the Company), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three months ended March 31, 2008 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company's 2007 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at www.nationalbankshares.com.

Note (2) Stock-Based Compensation

The Company adopted the National Bankshares, Inc. 1999 Stock Option Plan to give key employees of NBI 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 NBI 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. At the discretion of the Stock Option Committee options may be awarded with the provision that they may be accelerated upon a change of control, merger, consolidation, sale or dissolution of National Bankshares, Inc. At March 31, 2008, there were 286,000 additional shares available for grant under the plan. There were no nonvested shares outstanding at March 31, 2008.

Compensation expense is calculated using the Black-Scholes model and is amortized over the requisite service period using the straight-line method. There have been no grants of stock options in 2008.

| Options | Shares | Weighted- | Weighted | Aggregate |
|---------|--------|-----------|----------|-----------|
|---------|--------|-----------|----------|-----------|

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| | | | Average Exercise Price | Average Remaining Contractual Term | Intrinsic Value (\$000) |
|--------------------------------|---------|----|---------------------------------------|---|--|
| Outstanding at January 1, 2008 | 145,000 | \$ | 21.46 | | |
| Granted | --- | | | | |
| Exercised | --- | | | | |
| Forfeited or expired | --- | | | | |
| Outstanding at March 31, 2008 | 145,000 | \$ | 21.46 | 5.85 | \$ --- |
| Exercisable at March 31, 2008 | 145,000 | \$ | 21.46 | 5.85 | \$ --- |

Because no options have been granted in 2008 and all options were fully vested at December 31, 2007, there is no expense included in net income.

During the three months ended March 31, 2008, there were no stock options granted or exercised. For the three months ended March 31, 2007 there were no stock options granted and 6,000 options were exercised with an intrinsic value of \$83,000.

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

| (\$ in thousands, except % data) | For the periods ended | | |
|---|-----------------------|----------|----------------------|
| | March 31, 2008 | 2007 | December 31, 2007 |
| Balance at beginning of period | \$ 5,219 | \$ 5,157 | \$ 5,157 |
| Provision for loan losses | 100 | (3) | 423 |
| Loans charged off | (152) | (136) | (471) |
| Recoveries | 61 | 27 | 110 |
| Balance at the end of period | \$ 5,228 | \$ 5,045 | \$ 5,219 |
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees | 0.99 % | 1.00 % | 1.00 % |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees ¹ | 0.07 % | 0.09 % | 0.07 % |
| Ratio of allowance for loan losses to nonperforming loans ² | 396.36 % | 445.76 % | 453.83 % |

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

| (\$ in thousands, except % data) | March 31, | | December 31, | |
|--|-----------|----------|--------------|---|
| | 2008 | 2007 | 2007 | |
| Nonperforming Assets: | | | | |
| Nonaccrual loans | \$ 1,319 | \$ 1,132 | \$ 1,150 | |
| Restructured loans | --- | --- | --- | |
| Total nonperforming loans | 1,319 | 1,132 | 1,150 | |
| Foreclosed property | 270 | 251 | 263 | |
| Total nonperforming assets | \$ 1,589 | \$ 1,383 | \$ 1,413 | |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 0.30 % | .27 % | .27 % | % |

| (\$ in thousands, except % data) | March 31, | | December 31, | |
|---|-----------|----------|--------------|---|
| | 2008 | 2007 | 2007 | |
| Loans past due 90 days or more and still accruing | \$ 1,392 | \$ 327 | \$ 1,181 | |
| Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees | 0.26 % | 0.06 % | 0.23 % | % |
| Impaired loans | | | | |
| Total impaired loans | \$ 1,319 | \$ 1,132 | \$ 1,144 | |
| Impaired loans with a valuation allowance | --- | --- | --- | |
| Valuation allowance | --- | --- | --- | |

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| | | | |
|---|-----------------|----------|----------|
| Impaired loans, net of allowance | --- | --- | --- |
| Impaired loans with no valuation allowance | \$ 1,319 | \$ 1,132 | 1,144 |
| Average recorded investment in impaired loans | \$ 1,235 | \$ 818 | \$ 1,138 |
| Income recognized on impaired loans | \$ --- | \$ --- | \$ --- |
| Amount of income recognized on a cash basis | \$ --- | \$ --- | \$ --- |

There were no nonaccrual loans excluded from impaired disclosure under SFAS 114 at March 31, 2008. No income was recognized on these loans for the period ended March 31, 2007. At December 31, 2007 there were \$6 in nonaccrual loans excluded from impaired disclosure under SFAS 114.

Note (4) Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for the sale by major security type as of March 31, 2008 are as follows:

| | March 31, 2008 | | | |
|---|----------------|------------|------------|------------|
| | | Gross | Gross | |
| | Amortized | Unrealized | Unrealized | Fair |
| | Costs | Gains | Losses | Values |
| (\$ in thousands) | | | | |
| Available for sale: | | | | |
| U.S. Treasury | \$ 3,028 | \$ 182 | \$ --- | \$ 3,210 |
| U.S. Government Agencies and Corporations | 11,980 | 485 | --- | 12,465 |
| State and political subdivisions | 82,402 | 1,722 | 133 | 83,991 |
| Mortgage-backed securities | 24,796 | 594 | 5 | 25,385 |
| Corporate debt securities | 31,398 | 234 | 239 | 31,393 |
| Federal Reserve Bank stock-restricted | 92 | --- | --- | 92 |
| Federal Home Loan Bank stock-restricted | 1,693 | --- | --- | 1,693 |
| Other securities | 3,062 | 96 | 85 | 3,073 |
| Total securities available for sale | \$ 158,451 | \$ 3,313 | \$ 462 | \$ 161,302 |

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type as of March 31, 2008 are as follows:

| | March 31, 2008 | | | |
|---|----------------|------------|------------|------------|
| | | Gross | Gross | |
| | Amortized | Unrealized | Unrealized | Fair |
| | Costs | Gains | Losses | Values |
| (\$ in thousands) | | | | |
| Held to Maturity: | | | | |
| U.S. Government Agencies and Corporations | \$ 36,959 | \$ 713 | \$ 9 | \$ 37,663 |
| State and political subdivisions | 65,126 | 1,542 | 120 | 66,548 |
| Mortgage-backed securities | 2,006 | 53 | --- | 2,059 |
| Corporate securities | 12,099 | 129 | 211 | 12,017 |
| Total securities held to maturity | \$ 116,190 | \$ 2,437 | \$ 340 | \$ 118,287 |

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Information pertaining to securities with gross unrealized losses at March 31, 2008 and December 31, 2007, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| (\$ in thousands) | March 31, 2008 | | | |
|---|----------------------------|----------------------------|--------------------------|----------------------------|
| | Less Than 12 Months | | 12 Months or More | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Government agencies and corporations | \$ 990 | \$ 9 | \$ --- | \$ --- |
| State and political subdivisions | 14,896 | 239 | 1,449 | 13 |
| Mortgage-backed securities | 1 | --- | 723 | 5 |
| Corporate debt securities | 6,460 | 82 | 17,355 | 369 |
| Other | 221 | 85 | --- | --- |
| Total temporarily impaired securities | \$ 22,568 | \$ 415 | \$ 19,527 | \$ 387 |

| (\$ in thousands) | December 31, 2007 | | | |
|---|---------------------|------------|-------------------|------------|
| | Less Than 12 Months | | 12 Months or More | |
| | Fair | Unrealized | Fair | Unrealized |
| | Value | Loss | Value | Loss |
| U.S. Treasury | \$ --- | \$ --- | \$ 949 | \$ 6 |
| U.S. Government agencies and corporations | --- | --- | 8,162 | 25 |
| State and political subdivisions | 12,622 | 255 | 29,085 | 239 |
| Mortgage-backed securities | --- | --- | 10,455 | 79 |
| Corporate debt securities | 1,893 | 77 | 34,965 | 865 |
| Total temporarily impaired securities | \$ 14,516 | \$ 332 | \$ 83,661 | \$ 1,214 |

The Company had 55 securities with a fair value of \$42,095 which were temporarily impaired at March 31, 2008. The total unrealized loss on these securities was \$802. 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 or until the cost is recovered. Therefore, the losses associated with these securities are considered temporary at March 31, 2008. All securities shown are above investment grade.

Note (5) Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), *Business Combinations* (SFAS 141(R)). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction; establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder's fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and early implementation is not permitted. The Company does not expect the implementation to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160) SFAS 160 requires an entity to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*(SFAS 161) SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

Note (6) Defined Benefit Plan

Components of Net Periodic Benefit Cost

| (\$ in Thousands) | Pension Benefits | |
|------------------------------------|------------------------------|--------|
| | Three Months Ended March 31, | |
| | 2008 | 2007 |
| Service cost | \$ 107 | \$ 152 |
| Interest cost | 154 | 175 |
| Expected return on plan assets | (167 |) (159 |
| Amortization of prior service cost | (25 |) 2 |

| | | | | |
|--|--------|---|--------|---|
| Amortization of net obligation at transition | (3 |) | (3 |) |
| Recognized net actuarial loss | 39 | | 45 | |
| Net periodic benefit cost | \$ 105 | | \$ 212 | |

Employer Contributions

NBI's required minimum pension plan contribution for 2008 is \$395. The contribution will be paid in quarterly installments.

Note (7) Fair Value Measurements

SFAS No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Securities

Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy. Currently, all of the Company's securities are considered to be Level 2 securities.

Loans held for sale

Loans held for sale which is required to be measured in a lower of cost or fair value. Under SFAS No. 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At March 31, 2008, the entire balance of loans

held for sale was recorded at its cost.

Impaired loans

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

National Bankshares, Inc. and Subsidiaries

(In thousands, except per share data)

Item 2.

Management's Discussion and Analysis of Financial Condition and

Results of Operations for the Three Months Ended March 31, 2008

The purpose of this discussion is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the Company), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Refer to the financial statements and other information included in this report as well as the 2007 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

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

Critical Accounting Policies

General

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

Allowance for Loan Losses

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

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Our allowance for loan losses includes two basic components: estimated credit losses on individually evaluated loans that are determined to be impaired, and estimated credit losses inherent in the remainder of the loan portfolio. Under SFAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. An individually evaluated loan that is determined not to be impaired under SFAS 114 is evaluated under SFAS 5 when specific characteristics of the loan indicate that it is probable there would be estimated credit losses in a group of loans with those characteristics.

SFAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility nor does it specify how an institution should determine that a loan is impaired. National Bank uses its standard loan review procedures in making those judgments so that allowance estimates are based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio. Also the loan loss allowance takes into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political considerations. For loans within the scope of SFAS 114 that are individually evaluated and found to be impaired, the associated allowance is based on upon one of the three impairment measurement methods specified in SFAS 114.

All other loans, including individually evaluated loans determined not to be impaired under SFAS 114, are included in a group of loans that are measured under SFAS 5 to provide for estimated credit losses that have been incurred on groups of loans with similar risk characteristics. Our methodology for measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with SFAS 5 is based on each group's historical net charge-off rate, adjusted for the effects of the qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience.

Finally, a component of the allowance may be labeled “unallocated” and is appropriate when it reflects estimated credit losses determined in accordance with GAAP, and when it is properly supported and documented.

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 on the consolidated balance sheets in the amount of \$9,958 and \$10,912 at December 31, 2003 and 2002, respectively, did not constitute the acquisition of a business, and therefore will continue to be amortized.

Overview

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

Performance Summary

The following table shows NBI’s key performance ratios for the period ended March 31, 2008 and December 31, 2007.

| | March 31, 2008 | | December 31, 2007 | |
|--------------------------|---------------------------|---|------------------------------|---|
| Return on average assets | 1.44 | % | 1.46 | % |

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| | | | | | |
|--------------------------------------|----|-------|---|-------|------|
| Return on average equity | | 11.95 | % | 12.60 | % |
| Net interest margin (1) | | 3.93 | % | 3.98 | % |
| Noninterest margin (2) | | 1.56 | % | 1.41 | % |
| Basic net earnings per share | \$ | 0.46 | | \$ | 1.82 |
| Fully diluted net earnings per share | \$ | 0.46 | | \$ | 1.82 |

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

The return on average assets for the first quarter of 2008 was 1.44%, down 2 basis points from the 1.46% in the period ended December 31, 2007, as asset growth outpaced growth in earnings. The return on average equity dropped from 12.60% at year-end to 11.95% at the end of the first quarter.

Growth

The following table shows NBI's key growth indicators:

| | March 31, 2008 | December 31, 2007 |
|--------------|-----------------------|--------------------------|
| Securities | \$ 277,492 | \$ 273,343 |
| Loans, net | 522,343 | 518,435 |
| Deposits | 795,085 | 776,339 |
| Total assets | 911,721 | 887,647 |

Each of the Company's key growth indicators improved in the first quarter of 2008. Growth in net loans and deposits was internally generated and was managed with the goal of minimizing the negative impact on the net interest margin and to maintain loan portfolio quality.

Asset Quality

Key asset quality indicators are shown below:

| | March 31, 2008 | December 31, 2007 | | |
|------------------------------------|-----------------------|--------------------------|-------|---|
| Nonperforming loans | \$ 1,319 | \$ | 1,150 | |
| Loans past due over 90 days | 1,392 | | 1,181 | |
| Other real estate owned | 270 | | 263 | |
| Allowance for loan losses to loans | 0.99 | % | 1.00 | % |
| Net charge-off ratio | 0.07 | % | 0.07 | % |

Nonperforming loans at March 31, 2008, all of which were nonaccrual loans, were \$1,319, or 0.25% of loans net of unearned income. One loan accounted for the majority of the nonperforming loans total. Nonperforming loans increased by \$169 over the \$1,150 reported on December 31, 2007. Loans past due over 90 days at the end of the first quarter of 2008 were \$1,392, up by \$211 over the total at year-end. After quarter-end, one additional loan of \$900 was placed in nonaccrual. The loan is well secured, and management does not anticipate a significant loss at this time. Although there were increases in both categories from year-end, totals remained good when compared with peers and when viewed from the Company's own historical perspective.

Net Interest Income

Net interest income for the period ended March 31, 2008 was \$7,304 an increase of \$190, or 2.67%, when compared with the same period in 2007. This increase is attributable to an increase in the volume of earning assets.

The amount of net interest income earned is affected by various factors. These include changes in market interest rates due to the Federal Reserve Board's monetary policy, as well as the level and composition of the earning assets and interest-bearing liabilities. The Company has some ability to respond to interest rate movements and reduce volatility in the net interest margin. However, the frequency and magnitude of changes in market interest rates are difficult to predict, and these changes may have a greater impact on net interest income than any adjustments by management.

Interest rates have declined recently, and if interest rates stabilize at their current level or drop further in the future, it will have a positive effect. Offsetting the effect of declining interest rates are higher rate investment securities, which can be called when interest rates fall, so that the issuer can refinance its debt at a lower rate. In addition, in order to retain loans in a competitive market, interest rates must sometimes be lowered on existing loans. If interest rates rise, particularly if they increase quickly, there could be a negative effect on earnings. The Company's interest-bearing liabilities reprice more quickly than its interest-earning assets. In the current uncertain economy, it is difficult to predict the direction and timing of future interest rate changes.

The primary source of funds used to support the Company's interest-earning assets is deposits. Deposits are obtained in the Company's trade area through traditional marketing techniques. Other funding sources, such as the Federal Home Loan Bank, while available, are only used occasionally. The cost of funds is dependent on interest rate levels and competitive factors. This limits the ability of the Company to react to interest rate movements.

Provision and Allowance for Loan Losses

The provision for loan losses for the three-month period ended March 31, 2008 was \$100. The ratio of the allowance for loan losses to total loans at the end of the first three months of 2008 was 0.99%, which compares to 1.00% at December 31, 2007. The net charge-off ratio was 0.07% at March 31, 2008 and 0.07% at December 31, 2007.

During the first quarter of 2008, management added to the provision for loan losses in an amount sufficient to account for the growth in the loan portfolio. Loan quality indicators are closely monitored, and management regularly evaluates the sufficiency of the allowance for loan losses based upon its opinion of current asset quality and the rate of loan growth.

Noninterest Income

| | March 31, 2008 | March 31, 2007 | Percent Change | |
|------------------------------------|-----------------------|-----------------------|-----------------------|----|
| Service charges on deposits | \$ 768 | \$ 810 | (5.19 | %) |
| Other service charges and fees | 84 | 83 | 1.20 | % |
| Credit card fees | 637 | 598 | 6.52 | % |
| Trust fees | 303 | 373 | (18.77 | %) |
| Other income | 221 | 264 | (16.29 | %) |
| Realized securities gains (losses) | 283 | 51 | 454.90 | % |

Service charges on deposit accounts totaled \$768 at March 31, 2008. This is a decline of \$42, or 5.19%, from the end of the first quarter of 2007. This category is affected by the number of deposit accounts, the level of service charge fees and the number of checking account overdrafts. The decline resulted from a drop in checking account overdrafts.

Other service charges and fees includes charges for official checks, income from the sale of checks to customers, safe deposit rent, fees for letters of credit and the income earned from commission on the sale of credit life, accident and health insurance. These fees increased slightly, from \$83 at March 31, 2007, to \$84 at March 31, 2008.

Internal growth from a higher volume of credit card accounts, transactions and merchant transactions resulted in credit card fees of \$637 at March 31, 2008. This was an increase of 6.52% over the \$598 total reported at the same period last year.

Trust fees, at \$303, were down by 18.77% from the \$373 earned in the first quarter of 2007. Trust income varies depending on the number of Trust accounts, the types of accounts under management and financial market conditions. The decline in Trust fees is attributable to a combination of all three factors. The financial markets declined during the first quarter of 2008, negatively affecting income. In addition, there are fewer accounts under management. The mix of account types also affected Trust fees during the quarter.

Other income is income that cannot be classified in another category. Some examples include 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. Other income at March 31, 2008 was \$221. This represents a decline of \$43, or 16.29%, when compared with March 31, 2007. In 2007, the Company received a \$45 refund of an overpayment of 2006 West Virginia franchise tax, and there was none in 2007. This accounts for most of the difference in other income between the two periods.

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During the first quarter of 2008, the Company recognized \$290 in gains from the initial public offering of Visa, Inc. When the credit card processor went public, the Company was required to sell a portion of its Class B shares. This gain, offset by minor losses in called investment securities, is the source of the \$283 in realized securities gains at March 31, 2008.

Noninterest Expense

| | March 31, 2008 | March 31, 2007 | Percent Change | |
|---------------------------------------|-----------------------|-----------------------|-----------------------|----|
| Salaries and employee benefits | \$ 2,857 | \$ 2,841 | 0.56 | % |
| Occupancy and furniture and fixtures | 456 | 485 | (5.98 | %) |
| Data processing and ATM | 349 | 258 | 35.27 | % |
| Credit card processing | 460 | 447 | 2.91 | % |
| Intangibles and goodwill amortization | 284 | 284 | --- | |
| Net costs of other real estate owned | 14 | 58 | (75.86 | %) |
| Other operating expenses | 1,037 | 884 | 17.31 | % |

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Salary and benefits expense increased a nominal 0.56%, from \$2,841 March 31, 2007 to \$2,857 at March 31, 2008. The Company has made a concerted effort to control these costs.

Occupancy and furniture and fixtures expense was \$456 at the end of the first quarter of 2008, a decline of \$29, or 5.98%, from the same period last year. The drop reflects the Company's emphasis on containing controllable expenses.

Data processing and ATM expense was \$349 for the period ended March 31, 2008, an increase of \$91, or 35.27% over March 31, 2007. Most of the change is attributable to increased costs associated with an upgrade of the Company's data and telecommunications infrastructure and to increased maintenance expense for an investment in data processing software and hardware for branch capture check processing.

Credit card processing expense was \$460 at March 31, 2008, an increase of \$13, or 2.91%, over the total on March 31, 2007. This increase came about because of a higher volume of credit card, debit card and merchant accounts and transactions.

The expense for intangibles and goodwill amortization is related to acquisitions. There were no acquisitions in the past year, so the expense of \$284 is unchanged from March 31, 2007 to March 31, 2008.

Net costs of other real estate owned have decreased from \$58 at March 31, 2007 to \$14 at March 31, 2008. This expense category varies with the number of other real estate owned properties and the expenses associated with each. In the first quarter of 2007, there were \$30 in foreclosure costs which were not incurred in the first quarter of 2008.

The category of other operating expenses includes non-interest expense items such as franchise taxes, stationery and supplies, telephone costs, postage and charitable donations. Other operating expenses at March 31, 2008 were \$1,037. This reflects an increase of \$153, or 17.31%, when compared with the same period in 2007. The increased expense is the result of West Virginia franchise tax accruals of \$100, \$22 in higher postage expense and an increase in charitable donations made during the quarter.

Balance Sheet

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

| Assets | March 31, 2008 | December 31, 2007 | Percent Change | |
|--|-----------------------|--------------------------|-----------------------|---|
| Interest-bearing deposits | \$ 33,517 | \$ 14,180 | 136.37 | % |
| Securities available for sale | 161,426 | 163,210 | (1.09) | % |
| Securities held to maturity | 114,461 | 119,524 | (4.24) | % |
| Mortgage loans held for sale | 423 | 661 | (36.01) | % |
| Real estate construction loans | 49,415 | 41,620 | 18.73 | % |
| Real estate mortgage loans | 146,943 | 135,584 | 8.38 | % |
| Commercial and industrial loans | 216,138 | 214,387 | 0.82 | % |
| Loans to individuals | 112,584 | 119,626 | (5.89) | % |
| Total Assets | 889,104 | 867,061 | 2.54 | % |
| | | | | |
| Liabilities and stockholders equity | | | | |
| Noninterest-bearing demand deposits | \$ 108,435 | \$ 108,854 | (0.38) | % |
| Interest-bearing demand deposits | 240,111 | 223,771 | 7.30 | % |
| Savings deposits | 44,067 | 46,943 | (6.13) | % |
| Time deposits | 382,349 | 379,089 | 0.86 | % |

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| | | | | |
|----------------------|---------|---------|--------|----|
| Other borrowings | 63 | 626 | (89.94 | %) |
| Shareholders' equity | 107,036 | 100,597 | 6.40 | % |

Securities

Securities available for sale were \$161,302 at March 31, 2008, compared with \$158,594 at December 31, 2007. This represents an increase of \$2,708 when the two periods are compared.

Securities held to maturity totaled \$116,190 at the end of the first quarter of 2008, an increase of \$1,441, or 1.26%, when compared to the December 31, 2007 total of \$114,749.

Management regularly monitors the credit quality of the investment portfolio. The current uncertainty in the economy and the volatility in the financial markets is closely followed by Company management.

Loans

| | At period ended March 31, 2008 | | At period ended December 31, 2007 | Percent Change | |
|---------------------------|---|----|--|-----------------------|---|
| Commercial and industrial | \$ 219,346 | \$ | 216,830 | 1.16 | % |
| Real estate mortgage | 148,656 | | 145,542 | 2.14 | % |
| Real estate construction | 52,287 | | 46,697 | 11.97 | % |
| Loans to individuals | 108,395 | | 115,704 | (6.32) | % |
| Total loans | \$ 528,684 | \$ | 524,773 | 0.53 | % |

The Company's total loans increased from \$524,733 at year-end 2007 to \$528,684 at March 31, 2008. The \$3,911, or 0.75% increase is the result of growth in the commercial and industrial, real estate mortgage and real estate construction categories, offset by a decline in loans to individuals.

Real estate mortgage loans and real estate construction loans have experienced the greatest percentage of growth among the categories of loans. At December 31, 2007, there were \$145,542 in real estate mortgage loans, and there was \$148,656 outstanding at March 31, 2008, an increase of 2.14%. Since nearly all residential mortgage loans are sold on the secondary market, most of the growth in this category has been in commercial real estate loans. At December 31, 2007, real estate construction loans totaled \$46,697 compared with \$52,287 at March 31, 2008. It is policy to require a commitment for permanent mortgage financing from a secondary market mortgage lender prior to approving a residential construction loan. Most commercial real estate construction loans are converted to permanent mortgage loans and are held by the Company. This category of loans has historically been seasonal.

The 6.32% decline in loans to individuals continues a trend that has been evident over the past several years. The availability of low cost dealer auto loans and other products, such as home equity lines of credit, make traditional consumer installment loans less attractive to customers.

Deposits

| | At period ended March 31, 2008 | | At period ended December 31, 2007 | Percent Change | |
|----------------------------------|---|----|--|-----------------------|---|
| Noninterest-bearing deposits | \$ 118,554 | \$ | 113,361 | 4.58 | % |
| Interest-bearing demand deposits | 247,411 | | 237,772 | 4.05 | % |
| Saving deposits | 45,010 | | 44,349 | 1.49 | % |
| Time deposits | 384,110 | | 380,857 | 0.85 | % |
| Total deposits | \$ 795,085 | \$ | 776,339 | 2.41 | % |

Total deposits have increased by 2.41%, from \$776,339 at December 31, 2007 to \$795,085 on March 31, 2008. The growth was internally generated and was not the result of acquisitions. There has been solid growth in the noninterest bearing deposits category. At March 31, 2008,

this category totaled \$118,554, an increase of \$5,193, or 4.58%, over the \$113,361 total at the end of 2007.

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 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.

Net cash provided by operating activities for the quarter ended March 31, 2008 was \$4,070, which compares to \$3,849 at March 31, 2007.

Net cash used in investing activities in the first quarter of 2008 was \$19,938, compared to \$15,021 at March 31, 2007.

Net cash provided by financing activities for the period ended March 31, 2008 was \$18,286, and it was \$9,515 in the same period last year.

At March 31, 2008, management is unaware of any commitment that would have a material and adverse effect on liquidity.

Capital Resources

Total stockholders' equity at March 31, 2008 was \$108,957, an increase of \$4,157 from December 31, 2007. The Company repurchased stock totaling \$457 in the first quarter of 2007. The Tier I and Tier II risk-based capital ratio at March 31, 2008 were 15.29% and 16.14%, respectively.

Off-Balance Sheet Arrangements

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. 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.

There were no significant changes in these off-balance sheet arrangements during the first three months of 2008.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2007 in the Company's Form 10-K.

Item 4. Controls and Procedures

Under the supervision and with the participation of management, including the Company's principal executive officer and principal financial officer, the Company has conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures as of March 31, 2008. Based on that evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures are effective to give reasonable assurance in alerting them in a timely fashion to material information relating to the Company that is required to be included in the reports the Company files under the Act. There were no changes in the Company's internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially

affect, the Company's internal control over financial reporting.

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

Part II

Other Information

Item 1. Legal Proceedings

There were no material legal proceedings for the three months ended March 31, 2008.

Item 1A. Risk Factors

No material changes from risk factors as previously disclosed in the Form 10-K for the period ended December 31, 2007.

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

The following table provides information about our purchases during the first quarter of 2008 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act.

| Fiscal Period | Total Number of Shares Purchased | Average Price Paid per Share(\$)(1) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2) | Approximate Number of Shares That May Yet Be Purchased Under the Plans or Programs(2) |
|----------------------|---|--|--|--|
| January 1-31 | 13,600 | 18.75 | 13,600 | 51,150 |
| February 1-29 | 6,900 | 20.73 | 6,900 | 44,250 |
| March 1-31 | 3,500 | 18.94 | 3,500 | 40,750 |

1. Average price per share includes commissions.
2. On May 9, 2007 the Board approved the repurchase of up to 100,000 shares of common stock in the period from June 1, 2007 through May 31, 2008.

Item 3. Defaults upon Senior Securities

None for the three months ended March 31, 2008.

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

None

Item 5. Other Information

None

Item 6. Exhibits

See
Index of
Exhibits.

Signatures

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

DATE: May 9, 2008

NATIONAL BANKSHARES, INC.

/s/ JAMES G. RAKES
James G. Rakes
Chief Executive Officer

/s/ J. ROBERT BUCHANAN
J. Robert Buchanan
Chief Financial Officer

Index of Exhibits

| Exhibit No. | Description | Page No. in Sequential System |
|-------------|--|--|
| 3(i) | Articles of Incorporation, as amended, of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993) |
| 3(i) | Articles of Amendment to Articles of Incorporation of National Bankshares, Inc., dated April 8, 2003 | (incorporated herein by reference to Exhibit 3(i) of the Annual Report on Form 10K for fiscal year ended December 31, 2003) |
| 3(i) | Amended and Restated Articles of Incorporation of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006) |
| 3(ii) | Amended By-laws of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3(ii) of the Annual Report on Form 10K for fiscal year ended December 31, 2007) |
| 4(i) | Specimen copy of certificate for National Bankshares, Inc. common stock | (incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993) |
| 4(i) | Article Four of the Articles of Incorporation of National Bankshares, Inc. included in Exhibit No. 3(a) | (incorporated herein by reference to Exhibit 4(b) of the Annual Report on Form 10K for fiscal year ended December 31, 1993) |
| 10(ii)(B) | Computer software license agreement dated June 18, 1990, by and between Information Technology, Inc. and The National Bank of Blacksburg | (incorporated herein by reference to Exhibit 10(e) of the Annual Report on Form 10K for fiscal year ended December 31, 1993) |
| *10(iii)(A) | National Bankshares, Inc. 1999 Stock Option Plan | (incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999) |
| *10(iii)(A) | Employment Agreement dated January 2002 between National Bankshares, Inc. and James G. Rakes | (incorporated herein by reference to Exhibit 10(iii)(A) of Form 10Q for the period ended June 30, 2002) |
| *10(iii)(A) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg | (incorporated herein by reference to Exhibit 10(iii)(A) of Form 10Q for the period ended September 30, 2002) |
| *10(iii)(A) | Change in Control Agreement dated January 5, 2003, between National Bankshares, Inc. and Marilyn B. Buhyoff | (incorporated herein by reference to Exhibit 10(iii)(A) of Form 10K for the period ended December 31, 2002) |
| *10(iii)(A) | | |

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| | Change in Control Agreement dated January 8, 2003, between National Bankshares, Inc. and F. Brad Denardo | (incorporated herein by reference to Exhibit 10 (iii) (A) of Form 10K for the period ended December 31, 2002) |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006) |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between Bank of Tazewell County and J. Robert Buchanan | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006) |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006) |

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| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between National Bankshares, Inc. and Marilyn B. Buhyoff | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006) |
| *10(iii)(A) | First Amendment to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007) |
| *10(iii)(A) | First Amendment to Bank of Tazewell County Salary Continuation Agreement for J. Robert Buchanan | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007) |
| *10(iii)(A) | First Amendment to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007) |
| *10(iii)(A) | First Amendment to National Bankshares, Inc. Salary Continuation Agreement for Marilyn B. Buhyoff | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007) |
| 31(i) | Section 906 Certification of Chief Executive Officer | Page 25 |
| 31(ii) | Section 906 Certification of Chief Financial Officer | Page 26 |
| 32(i) | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | Page 27 |
| 32(ii) | 18 U.S.C. Section 1350 Certification of Chief Financial Officer | Page 27 |

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

Exhibit No. 31(i)

CERTIFICATIONS UNDER SECTION 906 OF THE SARBANES OXLEY ACT OF 2002

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

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15 (e) and 15d – 15 (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

Date: May 9, 2008

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

Exhibit 31(ii)

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

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15 (e) and 15d – 15 (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purpose in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

Date: May 9, 2008

/s/ J. ROBERT BUCHANAN
J. Robert Buchanan
Treasurer
(Principal Financial Officer)

Exhibit 32 (i)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2008, I, James G. Rakes, President and Chief Executive Officer of National Bankshares, Inc. (Principal Executive Officer), hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended March 31, 2008, fully complies with the requirements of section 13(a) or 15 (d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended March 31, 2008, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

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

Exhibit 32 (ii)

CERTIFICATION OF CHIEF FINANCIAL OFFICER

PURSUANT TO 18 U.S.C. SECTION 1350

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In connection with the Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2008, I, J. Robert Buchanan, Treasurer (Principal Financial Officer) of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended March 31, 2008, fully complies with the requirements of section 13(a) or 15 (d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended March 31, 2008, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ J. ROBERT BUCHANAN

J. Robert Buchanan

Treasurer

(Principal Financial Officer)