

NATIONAL BANKSHARES INC

Form 10-K

March 08, 2013

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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, 2012

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  
P.O. Box 90002  
Blacksburg, VA 24062-9002  
(540) 951-6300

(Address and telephone number of principal executive offices)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§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, a non-accelerated filer or a smaller reporting company. See definition of “accelerated filer, large accelerated filer, and smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ]      Accelerated filer [x]      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 Act). Yes [ ]      No [x]

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 Governance) on June 30, 2012 (the last business day of the most recently completed second fiscal quarter) was approximately \$200,195,893. As of February 20, 2013, the registrant had 6,947,974 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 into which incorporated |
|---|---|
| National Bankshares, Inc. 2012 Annual Report to Stockholders                          | Part II                                   |
| National Bankshares, Inc. Proxy Statement for the 2013 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 governments from its headquarters in Blacksburg, Virginia and its twenty-four branch offices throughout southwest Virginia. NBB has telephone and internet banking and it operates twenty-three 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 debit and 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, 2012, NBB had total assets of \$1,101,345 and total deposits of \$946,939. NBB’s net income for 2012 was \$18,025, which produced a return on average assets of 1.67% and a return on average equity of 12.42%. Refer to Note 12 of the Notes to Consolidated Financial Statements for NBB’s risk-based capital ratios.

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 Infinex Investments, Inc. 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, 2012, 2011 and 2010 is set out in the following table.

| Period | Class of Service | Percentage of Total Revenues |
|--------|------------------|------------------------------|
|--------|------------------|------------------------------|

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|                   |                            |        |
|-------------------|----------------------------|--------|
| December 31, 2012 | Interest and Fees on Loans | 61.58% |
|                   | Interest on Investments    | 22.78% |
| December 31, 2011 | Interest and Fees on Loans | 62.57% |
|                   | Interest on Investments    | 22.75% |
| December 31, 2010 | Interest and Fees on Loans | 64.22% |
|                   | Interest on Investments    | 21.03% |

## Market Area

The Company's market area in southwest Virginia is made up of the counties of Montgomery, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It includes the independent cities of Radford and Galax, and the portions of Carroll and Grayson Counties that are adjacent to Galax. The Company 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 second largest university. A second state supported university, Radford University, is located nearby. State support for public colleges and universities, like Virginia Tech and Radford University, has been adversely affected by the recession and State budget considerations. In recent years, Virginia Tech's Corporate Research Center has brought a number of technology related companies to Montgomery County. However, the recession has slowed the growth of new jobs in the Center.

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 cycles of hiring and layoffs within the past several years. Pulaski and Galax have in the past been centers for furniture manufacturing. However, this industry has been declining because of growing furniture imports and the loss of demand. Several furniture companies have gone out of business in the recent past. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that was negatively affected by the economic decline. Montgomery County, Bluefield in Tazewell County and Abingdon in Washington County are regional retail centers and have facilities to provide basic health care for the region.

NBI'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.

Because NBI's market area is economically diverse and includes large public employers, it has historically avoided the most extreme effects of past economic downturns. However, because the current national and state economic problems have been severe and prolonged, most of the Company's market area is experiencing higher levels of unemployment and very slow economic growth. For the Company, the result is a higher number of loan defaults than its historical average and a lower loan demand.

## Competition

The banking and financial services industry in NBI'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 other financial institutions as well as 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 deep knowledge of its markets, 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 both subsidiaries, including audit, compliance, loan review and human resources, are at the holding company level, and fees are charged to the respective subsidiary for those services.

At December 31, 2012, NBI employed 19 full time employees, NBB had 192 full time equivalent employees and NBFS had 3 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 NBI and NBB's costs of doing business are accordingly higher. Legislative efforts to prevent a repeat of the 2008 financial crisis culminated in the Dodd-Frank Wall Street Reform Act of 2010. This legislation, together with existing and planned regulations, has dramatically increased the regulatory burden on commercial banks. The burden falls disproportionately on community banks like NBB, which must devote a higher proportion of their human and other resources to compliance than do their larger competitors. The financial crisis has also heightened the examination focus by banking regulators, particularly on real estate related assets and commercial loans. In the current environment, the potential for additional laws and regulations that will impact the Company, as well as heightened examination standards with regard to asset quality, cannot be ruled out. The following is a brief summary of certain laws, rules and regulations that affect NBI and NBB.

National Bankshares, Inc.

NBI is a bank holding company qualified as a financial 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 (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.

**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 and must approve the acquisition of ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company.

**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 major 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 additional and increased civil and criminal penalties for violations of securities laws.

**Capital and Related 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 are actively reviewing capital stress testing and liquidity requirements for banking organizations beyond current levels. Implementation of the so-called BASEL III accord has been delayed. NBI is unable to predict when the BASEL III requirements will be implemented or the extent to which they may be applied to community banking organizations like NBI.

Emergency Economic Stabilization Act of 2008. On October 14, 2008, the U.S. Treasury announced the Troubled Asset Relief Program ("TARP") under the Emergency Economic Stabilization Act of 2008. In the program, the Treasury was authorized to purchase up to \$250 billion of senior preferred shares in qualifying U.S. banks, saving and loan associations and bank and savings and loan holding companies. The amount of TARP funds was later increased to \$700 billion. The minimum subscription amount was 1% of risk-weighted assets and the maximum amount was the lesser of \$25 billion or 3% of risk-weighted assets. The Dodd-Frank Act (described below) reduced the amount attributed to \$475 billion. NBI did not participate in TARP.

American Recovery and Reinvestment Act of 2009. The ARRA was enacted in 2009 and includes a wide range of programs to stimulate economic recovery. In addition, it also imposed new executive compensation and corporate governance obligations on TARP Capital Purchase Program recipients. Because NBI did not participate in TARP, it is not affected by these requirements.

Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was signed into law on July 21, 2010. Its wide ranging provisions affect all federal financial regulatory agencies and nearly every aspect of the American financial services industry. Among the provisions of the Dodd-Frank Act that directly impact the Company is the creation of an independent Consumer Financial Protection Bureau (CFPB), which has the ability to write rules for consumer protections governing all financial institutions. All consumer protection responsibility formerly handled by other banking regulators is consolidated in the CFPB. It will also oversee the enforcement of all federal laws intended to ensure fair access to credit. For smaller financial institutions such as NBI and NBB, the CFPB will coordinate its examination activities through their primary regulators.

The Dodd-Frank Act contains provisions designed to reform mortgage lending, which includes the requirement of additional disclosures for consumer mortgages. The CFPB has begun implementing mortgage lending regulations to carry out its mandate. In addition, the Federal Reserve issued new rules, effective October 1, 2011, which had the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation.

Although the Dodd-Frank Act provisions themselves are extensive, the ultimate impact on the Company of this massive legislation is unknown. The Act provides that several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, shall issue regulations implementing major portions of the legislation, and this process is ongoing.

#### 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 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.

**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 Electronic Funds Transfer Act and the Fair Debt Collections Practices Act. NBB is required to comply with these laws and regulations in its dealings with customers. In addition, the CFPB has begun adopting rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. 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 FDIC. FDIC maintains a Deposit Insurance Fund (“DIF”) 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 DIF declines in relation to the total amount of insured deposits. In 2009, because of the troubled economy and the number of failed banks nationwide, there was pressure on the reserve ratio of the DIF. In order to rebuild the Fund and to help maintain public confidence in the banking system, on June 30, 2009, the FDIC imposed a special assessment of five basis points of NBB’s FDIC insured assets, minus Tier 1 capital. The special assessment, which was in addition to regular DIF assessments was payable on September 30, 2009. In an effort to further strengthen the Fund, on November 12, 2009 the FDIC adopted a rule requiring insured depository institutions (including NBB) to prepay their estimated quarterly regular risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012 on December 30, 2009. In 2011, the method for calculating the FDIC assessment changed from deposit based to asset based.

FDIC announced its Transaction Account Guarantee Program (“TAG”) on October 14, 2008. The TAG, which was a part of the Temporary Liquidity Guarantee Program, provided unlimited coverage for noninterest bearing deposit accounts for FDIC-insured institutions that elected to participate. NBB elected to participate in this program, and its DIF assessments increased to reflect the additional FDIC coverage. The TAG expired on December 31, 2012. The expiration of TAG is likely to cause an outflow of deposits from banks to money market funds.

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 NBI are applied to NBB by the 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. In addition, implementation of the BASEL III requirements could increase required capital minimums as well as compliance costs due to their complexity.

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 become 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 payments are 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. The Dodd-Frank Act permits the OCC to approve applications by national banks like NBB to establish de novo branches in any state in which a bank located in that state is permitted to establish a branch.

### 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 earnings. 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

Particularly because of uncertain economic conditions and the current political environment, 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 other financial service providers and increase the costs of compliance, or they could change the products that can be offered and the manner in which financial institutions do business. We cannot foresee how regulation of financial institutions may change in the future and how those changes might affect NBI.

## 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. The Company's proxy materials for the 2013 annual meeting of stockholders are also posted on a separate website at [www.nationalbanksharesproxy.com](http://www.nationalbanksharesproxy.com).

## Item 1A. Risk Factors

If recovery from the economic downturn slows further or recession returns, our credit risk will increase and there could be greater loan losses.

A further slowing in economic recovery or return to recession is likely to result in a higher rate of business closures and increased job losses in the region in which we do business. In addition, reduced State funding for the public colleges and universities that are large employers in our market area could have an adverse effect on employment levels and on the area's economy. These factors would increase the likelihood that more of our customers would become delinquent or default on their loans. A higher level of loan defaults could result in higher loan losses, which could adversely affect our performance.

An extended economic recovery or return to recession could increase the risk of losses in our investment portfolio. We hold both corporate and municipal bonds in our investment portfolio. A slow recovery or return to recession could increase the actual or perceived risk of default by both corporate and government issuers and, in either case, could adversely affect the value of these investments.

If the real estate market remains depressed for an extended period, our business could be negatively affected. A depressed real estate market can impact us in several ways. First, the demand for new real estate loans will decline, and existing loans may become delinquent. In addition, if there is a general devaluation in real estate, loan collateral values will decline.

Market interest rates are currently low. 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 may negatively affect our net interest income, because our interest-bearing liabilities (generally deposits) reprice sooner than our interest-earning assets (generally loans).

The allowance for loan losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, an allowance for loan losses is maintained to provide for loan losses. The allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect operating results. The allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating, and other outside forces and conditions, including changes in interest rates, all of which are beyond the Company's control; and these losses may exceed current estimates. Federal regulatory agencies, as an integral part of their examination process, review the Company's loans and allowance for loan losses. While management believes that the allowance for loan losses is adequate to cover current losses, it cannot make assurances that it will not further increase the allowance for loan losses or that regulators will not require it to increase this allowance. Either of these occurrences could adversely affect earnings.

The allowance for loan losses requires management to make significant estimates that affect the financial statements. Due to the inherent nature of this estimate, management cannot provide assurance that it will not significantly increase



the allowance for loan losses, which could materially and adversely affect earnings.

An increase in bank failures nationwide could significantly increase the cost of FDIC insurance.

Since insured depository institutions, including our bank, bear the full cost of deposit insurance provided by FDIC, a high number of bank failures could put additional pressure on a stressed Deposit Insurance Fund. This possibility could in turn lead to higher assessments that could negatively impact our earnings.

The expiration of the Transaction Guarantee Program may affect customer account retention and deposit levels.

The expiration on December 31, 2012 of the Dodd-Frank Act's modification and extension of the Transaction Account Guarantee Program ("TAG"), which provided unlimited coverage for noninterest bearing deposit accounts held at NBB, may have an impact on NBB's ability to attract and retain customer accounts and deposits as those customers may consider placing their funds in other institutions and financial vehicles in order to maximize FDIC insurance coverage. The Company and its subsidiaries may be required to place aside additional collateral to ensure the security and safety of customer accounts, including municipal accounts. While the effects of the TAG program expiration are uncertain, the potential loss of accounts and deposits may impact NBB's ability to make loans to small businesses and individuals.

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.

Additional laws and regulations could lead to a significant increase in our regulatory burden.

The Dodd-Frank Act and its implementing regulations will result in greater compliance costs and may reduce the profitability of some of our products and services. Implementation of the proposed BASEL III rules for capital could increase our compliance costs because of the complexity in the risk assessment rules among other things. Both federal and state governments could enact new laws affecting financial institutions that would increase our regulatory burden and could negatively affect our profits.

New laws and regulations could limit our sources of noninterest income.

New laws and regulations could limit our ability to offer certain profitable products and services or require that we offer unprofitable products and services. This could have a negative effect on the level of noninterest income.

Intense oversight by regulators could result in stricter requirements and higher overhead costs.

The regulatory environment could cause financial industry regulators to impose additional requirements, such as higher capital limits, which would impact the Company's earnings.

Political stalemates in the U.S. and world governments could negatively affect the financial markets.

Political stalemates in the U.S. and world governments could affect financial markets and affect fiscal policy which could negatively affect our investment portfolio and earnings.

Our information systems may experience an interruption or security breach.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our internet banking, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of our communications and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability.

Changes in funding for higher education could materially affect our business.

Federal and state support for public colleges and universities in the Company's market area has been adversely affected by the recession and budgetary considerations. As a result, our business may be adversely affected from declines in university programs, capital projects, employment and other related factors.

#### 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 nineteen branch

offices and it leases four. NBB owns a former branch building in Tazewell, Virginia that is actively marketing for sale. NBI owns a building in Pulaski, Virginia that it rents on a month-to-month basis and is actively marketing for sale. We believe that existing facilities are adequate for current needs and to meet anticipated growth.

## Item 3. Legal Proceedings

NBI, NBB, and NBFS are not currently involved in any material pending legal proceedings.

## Item 4. Mine Safety Disclosures

Not applicable.

## 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, 2012, there were 776 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 2012 and 2011.

## Common Stock Market Prices

|                | 2012     |          | 2011     |          | Dividends per share |        |
|----------------|----------|----------|----------|----------|---------------------|--------|
|                | High     | Low      | High     | Low      | 2012                | 2011   |
| First Quarter  | \$ 31.16 | \$ 25.95 | \$ 31.80 | \$ 27.46 | \$ ---              | \$ --- |
| Second Quarter | 30.65    | 28.60    | 29.71    | 24.08    | 0.53                | 0.48   |
| Third Quarter  | 35.82    | 29.18    | 27.23    | 22.93    | ---                 | ---    |
| Fourth Quarter | 33.82    | 29.03    | 29.00    | 23.21    | 0.57                | 0.52   |

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.

On May 9, 2012, NBI's Board of Directors approved the repurchase of up to 100,000 shares of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934. During 2012, there were no shares repurchased, and 100,000 shares may yet be purchased under the program.

## 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 Composite Index, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2007. These comparisons assume the investment of \$100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2007, and the reinvestment of dividends.

|                           | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------------------------|------|------|------|------|------|------|
| NATIONAL BANKSHARES, INC. | 100  | 119  | 179  | 206  | 190  | 228  |
| NASDAQ COMPOSITE INDEX    | 100  | 60   | 87   | 103  | 102  | 120  |
| NASDAQ BANK INDEX         | 100  | 78   | 66   | 75   | 67   | 80   |

## Item 6. Selected Financial Data

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

Year ended December 31,

|  | 2012      | 2011      | 2010      | 2009      | 2008      |
|--|-----------|-----------|-----------|-----------|-----------|
| <b>Selected Income Statement Data:</b> |           |           |           |           |           |
| Interest income                        | \$ 48,670 | \$ 49,946 | \$ 49,139 | \$ 50,487 | \$ 50,111 |
| Interest expense                       | 7,887     | 9,184     | 11,158    | 15,825    | 18,818    |
| Net interest income                    | 40,783    | 40,762    | 37,981    | 34,662    | 31,293    |
| Provision for loan losses              | 3,134     | 2,949     | 3,409     | 1,634     | 1,119     |
| Noninterest income                     | 8,739     | 8,410     | 8,347     | 8,804     | 9,087     |
| Noninterest expense                    | 23,396    | 23,338    | 23,127    | 23,853    | 22,023    |
| Income taxes                           | 5,245     | 5,247     | 4,223     | 3,660     | 3,645     |
| Net income                             | 17,747    | 17,638    | 15,569    | 14,319    | 13,593    |

**Per Share Data:**

|                         |       |       |       |       |       |
|-------------------------|-------|-------|-------|-------|-------|
| Basic net income        | 2.56  | 2.54  | 2.25  | 2.07  | 1.96  |
| Diluted net income      | 2.55  | 2.54  | 2.24  | 2.06  | 1.96  |
| Cash dividends declared | 1.10  | 1.00  | 0.91  | 0.84  | 0.80  |
| Book value              | 21.60 | 20.36 | 18.63 | 17.61 | 15.89 |

**Selected Balance Sheet****Data at End of Year:**

|                      |           |           |           |         |         |
|----------------------|-----------|-----------|-----------|---------|---------|
| Loans, net           | 583,813   | 580,402   | 568,779   | 583,021 | 569,699 |
| Total securities     | 352,043   | 318,913   | 315,907   | 297,417 | 264,999 |
| Total assets         | 1,104,361 | 1,067,102 | 1,022,238 | 982,367 | 935,374 |
| Total deposits       | 946,766   | 919,333   | 884,583   | 852,112 | 817,848 |
| Stockholders' equity | 150,109   | 141,299   | 129,187   | 122,076 | 110,108 |

**Selected Balance Sheet****Daily Averages:**

|                      |           |           |         |         |         |
|----------------------|-----------|-----------|---------|---------|---------|
| Loans, net           | 579,817   | 580,037   | 577,210 | 572,438 | 533,190 |
| Total securities     | 339,416   | 320,908   | 289,532 | 298,237 | 281,367 |
| Total assets         | 1,080,351 | 1,031,899 | 989,952 | 971,538 | 899,462 |
| Total deposits       | 925,986   | 888,044   | 852,953 | 846,637 | 783,774 |
| Stockholders' equity | 147,812   | 136,794   | 129,003 | 117,086 | 108,585 |

**Selected Ratios:**

|                                  |       |   |       |   |       |   |       |   |       |   |
|----------------------------------|-------|---|-------|---|-------|---|-------|---|-------|---|
| Return on average assets         | 1.64  | % | 1.71  | % | 1.57  | % | 1.47  | % | 1.51  | % |
| Return on average equity         | 12.01 | % | 12.89 | % | 12.07 | % | 12.23 | % | 12.52 | % |
| Dividend payout ratio            | 43.04 | % | 39.34 | % | 40.52 | % | 40.67 | % | 40.78 | % |
| Average equity to average assets | 13.68 | % | 13.26 | % | 13.03 | % | 12.05 | % | 12.07 | % |



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

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

Subsequent events have been considered through the date on which the Form 10-K was issued.

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

The recession continues to impact the national economy as well as the Company's market. Signs of economic recovery are mixed with continued high unemployment and diminished real estate values. The Company's trade area contains a diverse economy that includes large public colleges and universities, which somewhat insulated the Company's market from the dramatic declines in real estate values seen in some other areas of the country. Real estate values in the Company's market area saw moderate declines in 2009 and 2010 that appeared to stabilize in 2011 and 2012. Nonperforming assets fell in 2011 but increased slightly in 2012. If the economic recovery wavers or reverses,



it is likely that unemployment will continue at higher-than-normal levels or rise in the Company's trade area. Because of the importance to the Company's markets of state-funded universities, cutbacks in the funding provided by the State as a result of the recession could also negatively impact employment. This could lead to an even higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company's business and professional customers. In conclusion, a slow economic recovery could have an adverse effect on all financial institutions, including the Company.

#### Critical Accounting Policies

##### General

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

## Allowance for Loan Losses

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

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

### Impaired loans

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

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

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

Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment. Troubled debt restructurings with impairment losses remain in nonaccrual status.

### Collectively-evaluated loans

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

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

#### Estimation of the allowance for loan losses

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

The estimate of the allowance for December 31, 2012 considered market and portfolio conditions during 2012 as well as the elevated levels of delinquencies and net charge-offs in 2011. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see the notes to the financial statements, "Asset Quality," and "Provision and Allowance for Loan Losses."

#### Goodwill and Core Deposit Intangibles

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

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

Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company amortizes intangible assets arising from branch transactions over their useful life. Core deposit intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

#### Overview

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

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

#### Performance Summary

The following table presents NBI's key performance ratios for the years ending December 31, 2012 and December 31, 2011:

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|   | 12/31/12 |   | 12/31/11 |   |
|---|----------|---|----------|---|
| Return on average assets                    | 1.64     | % | 1.71     | % |
| Return on average equity                    | 12.01    | % | 12.89    | % |
| Basic net earnings per common share         | \$ 2.56  |   | \$ 2.54  |   |
| Fully diluted net earnings per common share | \$ 2.55  |   | \$ 2.54  |   |
| Net interest margin (1)                     | 4.38     | % | 4.59     | % |
| Noninterest margin (2)                      | 1.36     | % | 1.45     | % |

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

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

The return on average assets for the year ended December 31, 2012 was 1.64%, a decrease of 7 basis points from the 1.71% for the year ended December 31, 2011. The return on average equity decreased from 12.89% for the year ended December 31, 2011 to 12.01% for the year ended December 31, 2012.

Reflecting both the effects of the low interest rate environment throughout 2012 on NBI's funding costs and the Company's asset/liability management practices, the net interest margin decreased from 4.59% at year-end 2011 to 4.38% at December 31, 2012.

The noninterest margin decreased from 1.45% to 1.36% over the same period, while basic net earnings per common share increased from \$2.54 for the year ended December 31, 2011 to \$2.56 for the year ended December 31, 2012.

## Growth

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

|              | 12/31/12   | 12/31/11   |
|--------------|------------|------------|
| Securities   | \$ 352,043 | \$ 318,913 |
| Loans, net   | 583,813    | 580,402    |
| Deposits     | 946,766    | 919,333    |
| Total assets | 1,104,361  | 1,067,102  |

Securities, loans, and total assets all experienced growth in 2012, primarily funded by increases in customer deposits. Customer deposits grew \$27,433 or 2.98% from December 31, 2011, with increases mainly from municipal deposits and individuals seeking to safeguard principal by avoiding more volatile investments in financial markets. The liquidity provided by customer deposits supported growth in loans of \$3,692 or 0.63% and securities of \$33,130 or 10.39%.

In both 2011 and 2012, the Company's growth was internally generated and was not the result of acquisitions.

## Asset Quality

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

|   | 12/31/12 | 12/31/11 |
|---|----------|----------|
| Nonperforming loans(1)                      | \$ 5,617 | \$ 5,204 |
| Loans past due 90 days or more and accruing | 170      | 481      |
| Other real estate owned                     | 1,435    | 1,489    |
| Allowance for loan losses to loans(2)       | 1.41 %   | 1.37 %   |
| Net charge-off ratio                        | 0.49 %   | 0.43 %   |

(1) Nonperforming loans include nonaccrual loans plus restructured loans in nonaccrual status. Accruing restructured loans are not included.

(2) Loans are net of unearned income and deferred fees.

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. In 2012, the Company's asset quality remained at similar levels to those in 2011. Nonperforming loans were \$5,617 or 0.95% of loans net of unearned income and deferred fees. This compares to \$5,204 and 0.88% at December 31, 2011. Loans past due 90 days or more and still accruing at year-end 2012 totaled \$170, a decrease of \$311 or 64.66%, from \$481 at December 31, 2011. The net charge-off ratio increased slightly, from 0.43% for the year ended December 31, 2011 to 0.49% for the year ended December 31, 2012, while other real estate owned declined \$54 or 3.63% for the same period.

The Company's risk analysis determined an allowance for loan losses of \$8,349 at December 31, 2012, resulting in a provision for the year of \$3,134, an increase of \$185 or 6.27% from the \$2,949 for 2011. The ratio of the allowance for loan losses to loans increased to 1.41%, from 1.37% at December 31, 2011. The methodology for determining the allowance for loan losses relies on historical charge off-trends, modified by trends in nonperforming loans and economic indicators. More information about the level and calculation methodology of the allowance for loan losses is provided in "Balance Sheet – Loans – Risk Elements," "Balance Sheet – Loans – Troubled Debt Restructurings," as well as Notes 1 and 5 to the financial statements.

Sufficient resources have been dedicated to working out problem assets, and exposure to loss is somewhat mitigated because most of the nonperforming loans are collateralized. More information about nonaccrual and past due loans is provided in "Balance Sheet – Loans – Risk Elements." The Company continues to monitor risk levels within the loan portfolio and expects that any further increase in the allowance for loan losses would be the result of the refinement of loss estimates and would not dramatically affect net income.

## Net Interest Income

Net interest income for the period ended December 31, 2012 was \$40,783, an increase of \$21, or 0.05%, when compared to the prior year. The net interest margin for 2012 was 4.38%, compared to 4.59% for 2011. Total interest income for the period ended December 31, 2012 was \$48,670, a decrease of \$1,276 from the period ended December 31, 2011. Interest expense was down by \$1,297 during the same time frame, from \$9,184 for the year ended December 31, 2011 to \$7,887 for the year ended December 31, 2012. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates. In addition, noninterest-bearing deposits and low-rate interest-bearing deposits volume increased substantially. Please refer to the section titled "Analysis of Changes In Interest Income and Interest Expense" for further information related to rate and volume changes. In summary, the rates paid on the Company's deposit liabilities declined at a more rapid pace than the interest rates on its interest-earning assets.

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

During 2012, interest rates continued at historic lows. Offsetting the positive effect of low interest rates is the fact that some higher yielding securities in the Company's investment portfolio were called and were replaced with securities with yields at the lower market rate. Another negative effect of the low interest rate environment is the level of interest earned on overnight funds. This impacted the yield on the Company's interest-bearing deposits in other banks. The yield on these assets in 2012 was 0.25%, while the cost to fund them was 0.77% in the same period. These assets are used primarily to provide liquidity.

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.

The factors that may influence the Company's net interest margin include current Federal Reserve policies that depress long-term interest rates, and market forces that may encourage repricing of interest-bearing liabilities more quickly than interest-earning assets if rates were to increase. Because interest rates are at historic lows, interest rates will likely increase in the future. Management cannot predict the timing and level of interest rate increases.



## 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.

|  | December 31, 2012 |           |                    | December 31, 2011 |           |                    | December 31, 2010 |           |                    |
|--|-------------------|-----------|--------------------|-------------------|-----------|--------------------|-------------------|-----------|--------------------|
|  | Average Balance   | Interest  | Average Yield/Rate | Average Balance   | Interest  | Average Yield/Rate | Average Balance   | Interest  | Average Yield/Rate |
| Interest-earning assets:                     |                   |           |                    |                   |           |                    |                   |           |                    |
| Loans, net (1)(2)(3)                         | \$ 589,935        | \$ 35,744 | 6.06 %             | \$ 589,257        | \$ 36,813 | 6.25 %             | \$ 585,933        | \$ 37,282 | 6.36 %             |
| Taxable securities(4)                        | 167,874           | 6,613     | 3.94 %             | 155,765           | 6,745     | 4.33 %             | 123,920           | 5,588     | 4.51 %             |
| Nontaxable securities (1)(4)                 | 167,355           | 10,002    | 5.98 %             | 163,174           | 10,102    | 6.19 %             | 161,571           | 10,074    | 6.24 %             |
| Interest-bearing deposits                    | 94,724            | 240       | 0.25 %             | 64,977            | 155       | 0.24 %             | 55,477            | 128       | 0.23 %             |
| Total interest-earning assets                | \$ 1,019,888      | \$ 52,599 | 5.16 %             | \$ 973,173        | \$ 53,815 | 5.53 %             | \$ 926,901        | \$ 53,072 | 5.73 %             |
| Interest-bearing liabilities:                |                   |           |                    |                   |           |                    |                   |           |                    |
| Interest-bearing demand deposits             | \$ 420,947        | \$ 4,167  | 0.99 %             | \$ 378,971        | \$ 4,088  | 1.08 %             | \$ 322,705        | \$ 3,332  | 1.03 %             |
| Savings deposits                             | 64,973            | 36        | 0.06 %             | 58,273            | 45        | 0.08 %             | 54,543            | 51        | 0.09 %             |
| Time deposits                                | 298,797           | 3,684     | 1.23 %             | 314,920           | 5,051     | 1.60 %             | 352,887           | 7,775     | 2.20 %             |
| Total interest-bearing liabilities           | \$ 784,717        | \$ 7,887  | 1.01 %             | \$ 752,164        | \$ 9,184  | 1.22 %             | \$ 730,135        | \$ 11,158 | 1.53 %             |
| Net interest income and interest rate spread |                   | \$ 44,712 | 4.15 %             |                   | \$ 44,631 | 4.31 %             |                   | \$ 41,914 | 4.20 %             |
| Net yield on average interest-earning assets |                   |           | 4.38 %             |                   |           | 4.59 %             |                   |           | 4.52 %             |

(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 \$802 in 2012, \$729 in 2011 and \$863 in 2010 are included in total interest income.

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

(4) Daily averages are shown at amortized cost.



## 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).

|  | 2012 Over 2011 |           |                      | 2011 Over 2010 |           |                      |
|--|----------------|-----------|----------------------|----------------|-----------|----------------------|
|  | Changes Due To |           | Net Dollar<br>Change | Changes Due To |           | Net Dollar<br>Change |
|  | Rates(2)       | Volume(2) |                      | Rates(2)       | Volume(2) |                      |
| Interest income: (1)   |                |           |                      |                |           |                      |
| Loans  | \$ (1,111 )    | \$ 42     | \$ (1,069 )          | \$ (680 )      | \$ 211    | \$ (469 )            |
| Taxable securities   | (634 )         | 502       | (132 )               | (229 )         | 1,386     | 1,157                |
| Nontaxable securities  | (355 )         | 255       | (100 )               | (71 )          | 99        | 28                   |
| Interest-bearing deposits                                      | 10             | 75        | 85                   | 4              | 23        | 27                   |
| Increase (decrease) in income on interest-earning assets       | \$ (2,090 )    | \$ 874    | \$ (1,216 )          | \$ (976 )      | \$ 1,719  | \$ 743               |
| Interest expense:  |                |           |                      |                |           |                      |
| Interest-bearing demand deposits                               | \$ (352 )      | \$ 431    | \$ 79                | \$ 154         | \$ 602    | \$ 756               |
| Savings deposits   | (14 )          | 5         | (9 )                 | (9 )           | 3         | (6 )                 |
| Time deposits  | (1,119 )       | (248 )    | (1,367 )             | (1,952 )       | (772 )    | (2,724 )             |
| Increase (decrease) in expense of interest-bearing liabilities | \$ (1,485 )    | \$ 188    | \$ (1,297 )          | \$ (1,807 )    | \$ (167 ) | \$ (1,974 )          |
| Increase (decrease) in net interest income                     | \$ (605 )      | \$ 686    | \$ 81                | \$ 831         | \$ 1,886  | \$ 2,717             |

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2012, 2011 and 2010.

(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.

Total interest expense declined by \$1,297, while interest income on a taxable-equivalent basis decreased \$1,216, resulting in an increase of \$81 in taxable-equivalent net interest income when 2012 and 2011 are compared. Of this increase, \$686 was attributable to volume offset by a decline due to rates of \$605.

The lower interest rate environment led to a decline of \$1,069 in interest income from loans. The average balance of loans increased from \$589,257 in 2011 to \$589,935 in 2012, causing an increase in interest income of \$42, on a taxable-equivalent basis.

Interest income on taxable securities decreased \$634 due to rates, offset by an increase of \$502 due to average volume, for a net decrease of \$132 compared to 2011. The low interest rate environment increased the number of called securities in 2012 and reduced the opportunity to reinvest the proceeds in securities with more attractive yields. Because of low yields in the securities markets and flat loan demand, the Company priced deposits

accordingly.

Interest on time deposits declined \$1,367 from 2011 to 2012, with a decline of \$1,119 due to rates and \$248 attributable to volume. See "Net Interest Income" for additional information related to the decline in interest expense.

The low interest rate environment was also present in 2010. As compared with 2010, there was a \$2,724 decline in interest expense associated with time deposits in 2011. Of the total decline, \$1,952 was due to rates, and \$772 stemmed from lower deposit volume. Management focused on deposit pricing in 2010 and took advantage of falling rates to lower interest expense.

From 2010 to 2011 interest on loans decreased by \$469. Loan interest income attributable to rates was \$680 lower, offset partially by an increase of \$211 due to volume. As compared with 2010, there was an increase of \$2,717 in net interest income in 2011, \$831 of the increase was due to rates and \$1,886 due to volume.

#### 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. Among the tools available to management is interest rate sensitivity analysis, which provides information related to repricing opportunities. Interest rate shock simulations indicate potential economic loss due to future interest rate changes. Shock analysis is a test 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 the return on average assets and the return on average equity projected at December 31, 2012 and 2011. For purposes of this analysis, noninterest income and expenses are assumed to be flat.

| Rate Shift (bp) | Return on Average Assets |       | Return on Average Equity |        |
|-----------------|--------------------------|-------|--------------------------|--------|
|                 | 2012                     | 2011  | 2012                     | 2011   |
| 300             | 1.13%                    | 0.96% | 8.02%                    | 6.96%  |
| 200             | 1.35%                    | 1.13% | 9.53%                    | 8.19%  |
| 100             | 1.56%                    | 1.30% | 10.92%                   | 9.32%  |
| (-)100          | 1.95%                    | 1.62% | 13.51%                   | 11.51% |
| (-)200          | 1.82%                    | 1.58% | 12.61%                   | 11.23% |
| (-)300          | 1.55%                    | 1.46% | 10.85%                   | 10.39% |

Simulation analysis is another tool available to 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. In addition, competitive pressures can make it difficult to price deposits and loans in a manner that optimally minimizes interest rate risk. Therefore, 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

|                                    | Year Ended           |                      |                      |
|------------------------------------|----------------------|----------------------|----------------------|
|                                    | December<br>31, 2012 | December<br>31, 2011 | December<br>31, 2010 |
| Service charges on deposits        | \$ 2,594             | \$ 2,617             | \$ 2,858             |
| Other service charges and fees     | 243                  | 287                  | 317                  |
| Credit card fees                   | 3,278                | 3,197                | 2,954                |
| Trust fees                         | 1,313                | 1,087                | 1,118                |
| Bank-owned life insurance income   | 814                  | 762                  | 760                  |
| Other income                       | 472                  | 449                  | 354                  |
| Realized securities gains (losses) | 25                   | 11                   | (14)                 |
| Total noninterest income           | \$ 8,739             | \$ 8,410             | \$ 8,347             |

Service charges on deposit accounts totaled \$2,594 for the year ended December 31, 2012. This is a decline of \$23, or 0.88%, from \$2,617 for the year ended December 31, 2011. Service charges on deposit accounts decreased \$241, or 8.43%, from 2010 to 2011. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2012 decline resulted primarily from a decrease of \$53 in ATM transaction fees offset by a \$36 increase in overdraft fees. The Company removed two automatic teller machines in 2012 to obtain cost savings that is expected to exceed the associated decline in ATM fee income. The 2011 decline resulted from a decrease in fees from checking account overdrafts and fees for checks returned for insufficient funds. Other service charges and fees included charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees from letters of credit and income from commissions on the sale of credit life, accident and health insurance. These fees were \$243 for the year ended December 31, 2012, down by \$44, or 15.33%, from the \$287 for 2011. The total for the year ended December 31, 2011 was \$30 below the \$317 posted for the year ended December 31, 2010. The decline in 2012 and 2011 was primarily attributable to lower check sales, decreasing income by \$35 in 2012 and \$46 in 2011. This in turn, was attributed to increased customer adoption of debit cards and internet banking bill-pay.

Credit card fees for the year ended December 31, 2012, were \$81 above the \$3,197 reported for the year ended December 31, 2011. From 2010 to 2011, credit card fees increased \$243, or 8.23%. The increases in 2012 and 2011 are due to increased volume of merchant transaction fees and credit card fees.

Trust fees at \$1,313 increased by \$226 or 20.79% when the years ended December 31, 2012 and 2011 are compared, due to a large estate account that affected 2012. For the year ended December 31, 2011 trust fees were \$1,087, a decrease of \$31, or 2.77%, from 2010. 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 on the number and type of accounts under management and financial market conditions. The mix of account types also affected the level of Trust fees in 2011 and 2012.

Noninterest income from bank-owned life insurance (BOLI) increased, from \$762 for the year ended December 31, 2011 to \$814 for 2012. BOLI income for the year ended December 31, 2010 was \$760. The Company made an additional investment of \$1,900 in 2011. The growth in income in 2011 and 2012 was also affected by the performance of the variable rate policies.

Other income is income from smaller balance accounts that cannot be classified in another category. Some examples include net gains from the sales of fixed assets, rent from foreclosed properties and revenue from investment and insurance sales. Other income for 2012 was \$472, an increase of \$23, or 5.12%, when compared with \$449 for the year ended December 31, 2011. Other income for 2011 increased by \$95, or 26.84%, when compared with 2010. The increase from 2010 to 2011 was primarily due to refunds of prior years' franchise taxes from additional deductions discovered in 2011.

Realized securities net gains and losses for the three years presented were associated with called securities. There were no securities sold in 2012, 2011 or 2010.

#### Noninterest Expense

|                                      | Year Ended   |              |              |
|--------------------------------------|--------------|--------------|--------------|
|                                      | December 31, | December 31, | December 31, |
|                                      | 2012         | 2011         | 2010         |
| Salaries and employee benefits       | \$ 12,005    | \$ 11,357    | \$ 10,963    |
| Occupancy, furniture and fixtures    | 1,589        | 1,599        | 1,875        |
| Data processing and ATM              | 1,593        | 1,701        | 1,499        |
| FDIC assessment                      | 475          | 677          | 1,080        |
| Credit card processing               | 2,442        | 2,485        | 2,300        |
| Intangibles amortization             | 1,083        | 1,083        | 1,083        |
| Net costs of other real estate owned | 208          | 518          | 214          |
| Franchise taxes                      | 901          | 780          | 963          |
| Other operating expenses             | 3,100        | 3,138        | 3,150        |
| Total noninterest expense            | \$ 23,396    | \$ 23,338    | \$ 23,127    |

Salary and benefits expense increased \$648, or 5.71%, from \$11,357 for the year ended December 31, 2011 to \$12,005 for 2012. The increase is primarily the result of \$325 increase in health benefits. The remaining increase in 2012 was the result of normal compensation and staffing decisions. The increase of \$394, or 3.59% from 2010 to 2011 was also the result of normal compensation and staffing decisions.

Occupancy, furniture and fixtures expense was \$1,589 for the year ended December 31, 2012, a decrease of \$10, or 0.63%, from the prior year. The 2011 total was \$1,599, a decrease of \$276, or 14.72%, from the \$1,875 reported at year-end 2010. The declines in 2012 and 2011 are reflective of the Company's emphasis on containing controllable expenses.

Data processing and ATM expense was \$1,593 in 2012, \$1,701 in 2011 and \$1,499 in 2010. The decrease of \$108 or 6.35% from 2011 to 2012 resulted primarily from declines in maintenance expenses and communications infrastructure expenses. The increase from 2010 to 2011 of \$202 was associated with infrastructure upgrades.

When the years ended December 31, 2012 and December 31, 2011 are compared, there was a decrease in the Federal Deposit Insurance Corporation Deposit Insurance Fund assessment of \$202. The total expense for 2011 was \$677, which compares with \$475 for 2012. The FDIC assessment is accrued based on a method provided by the FDIC. During 2011, the method changed from a deposit based to an asset based method. This resulted in a reduced amount of expense for the Company in 2011 and 2012. The FDIC assessment expense for the year ended December 31, 2011 fell \$403 from \$1,080 for 2010. Given the severe impact of the economic downturn on some of the nation's banks, the Company has no assurance that the FDIC will not increase assessments on insured banks to maintain the integrity of the Deposit Insurance Fund.

Credit card processing expense was \$2,442 for the period ended December 31, 2012, a decrease of \$43, or 1.73% from 2011's total of \$2,485. Credit card processing expense in 2011 increased \$185, or 8.04% from 2010. This expense is driven by the volume of credit card, debit card and merchant account transactions and by the level of merchant discount fees. It is subject to a degree of variability.

The expense for intangibles and goodwill amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2012 remained flat from 2011 and 2010 at \$1,083.

Net costs of other real estate owned decreased from \$518 for the period ended December 31, 2011 to \$208 for the year ended December 31, 2012. From 2010 to 2011, net costs of other real estate owned increased \$304 from \$214. This expense category varies with the number of foreclosed properties owned by NBB and with the expense associated with each. It includes write-downs on other real estate owned plus other costs associated with carrying these properties, as well as net gains or losses on the sale of other real estate. In 2012, write-downs on other real estate were \$76. This compares with \$327 in 2011. The Company accounts for other real estate at fair value, using current appraisals. Updated appraisals reflected declines in the value of some properties. Other costs for these properties in 2012 were \$222, while they were \$184 in 2011. There was a total of \$90 in net gains on the sale of other real estate for 2012 and \$7 in net losses for 2011. Because the Company's market area continues to experience the effects of the prolonged recession, it is anticipated that there will be additional foreclosures in the near future. This may result in an associated increase in the costs of other real estate owned.



Franchise taxes were \$901 for the period ended December 31, 2012 and \$780 for 2011, an increase of \$121 or 15.51%. Franchise tax expense decreased \$183 in 2011 from \$963 in 2010. Franchise tax expense in 2011 benefitted from additional deductions discovered in 2011 and applied to prior year's returns. State bank franchise taxes are based upon total equity, which increased in both 2011 and 2012.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs and charitable donations. For the year ended December 31, 2012, other operating expenses were \$3,100. This compares with \$3,138 for 2011 and \$3,150 for 2010. The nominal \$37 decrease from 2011 to 2012 is the result of changes in several categories of expense, with no one item making a significant contribution to the total.

#### Income Taxes

Income tax expense for 2012 was \$5,245 compared to \$5,247 in 2011 and \$4,223 in 2010. Tax exempt income is the primary difference between expected and actual income tax expense. The Company's effective tax rates for 2012, 2011 and 2010 were 22.81%, 22.93% and 21.34%, 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

In 2012, the Company saw improvements in some asset quality indicators, including the balance of impaired loans, classified loans, loans 90 days past due and still accruing, and other real estate owned, but slight weakening in other indicators, such as net charge-offs, assets rated "special mention" and nonaccrual loans. While, historically, national economic downturns have affected the Company's market area less severely than other areas of the country, downturns and recoveries typically have a delayed effect on the Company's local economy.

At December 31, 2012, total nonperforming assets were \$7,052 compared to \$6,693 at December 31, 2011. See "Balance Sheet – Loans – Risk Elements" for additional detail about nonperforming assets. Net charge-offs increased by \$308, with the ratio of net charge-offs to average loans increasing 6 basis points, from 0.43% in 2011 to 0.49% in 2012.

The Company's internal credit risk analysis takes into consideration trends in nonperforming loans and charge-offs. Based on the analysis, the Company increased the allowance for loan losses to \$8,349, or 1.41% of loans at December 31, 2012. At December 31, 2011, the allowance for loan losses was \$8,068, or 1.37% of loans. The provision for loan losses for 2012 was \$3,134, an increase of \$185 from 2011.

The current level of nonperforming assets is manageable in management's opinion. Core earnings remain strong, and there are sufficient resources available to deal with these assets.

As previously mentioned, the level of nonperforming assets is primarily influenced by local economic conditions. A high degree of uncertainty remains concerning the speed of recovery, and in particular the speed of the recovery in the Company's relatively limited market area. For that reason, management is unable to predict with any degree of certainty whether and how much its asset quality may improve or deteriorate. Based on current information, management believes the level of nonperforming assets will continue to compare well with peers, but may be high when considering its own historic level of nonperforming assets. Please see "Critical Accounting Policies" above for

additional information.

## Quarterly Results of Operations

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2012, 2011 and 2010:

|   | 2012             |                   |                  |                   |
|---|------------------|-------------------|------------------|-------------------|
|   | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Income Statement Data:                    |                  |                   |                  |                   |
| Interest income                           | \$ 12,114        | \$ 12,182         | \$ 12,237        | \$ 12,137         |
| Interest expense                          | 2,117            | 2,018             | 1,936            | 1,816             |
| Net interest income                       | 9,997            | 10,164            | 10,301           | 10,321            |
| Provision for loan losses                 | 672              | 1,104             | 778              | 580               |
| Noninterest income                        | 2,152            | 2,283             | 2,108            | 2,196             |
| Noninterest expense                       | 5,711            | 5,731             | 6,088            | 5,866             |
| Income taxes                              | 1,337            | 1,272             | 1,250            | 1,386             |
| Net income                                | \$ 4,429         | \$ 4,340          | \$ 4,293         | \$ 4,685          |
| Per Share Data:                           |                  |                   |                  |                   |
| Basic net income per common share         | \$ 0.64          | \$ 0.63           | \$ 0.62          | \$ 0.67           |
| Fully diluted net income per common share | 0.64             | 0.62              | 0.62             | 0.67              |
| Cash dividends per common share           | ---              | 0.53              | ---              | 0.57              |
| Book value per common share               | 20.86            | 21.14             | 21.66            | 21.60             |
|   |                  |                   |                  |                   |
|   | 2011             |                   |                  |                   |
|   | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Income Statement Data:                    |                  |                   |                  |                   |
| Interest income                           | \$ 12,465        | \$ 12,475         | \$ 12,577        | \$ 12,429         |
| Interest expense                          | 2,379            | 2,346             | 2,282            | 2,177             |
| Net interest income                       | 10,086           | 10,129            | 10,295           | 10,252            |
| Provision for loan losses                 | 800              | 753               | 643              | 753               |
| Noninterest income                        | 1,934            | 2,090             | 2,129            | 2,257             |
| Noninterest expense                       | 6,084            | 6,025             | 5,887            | 5,342             |
| Income taxes                              | 1,112            | 1,225             | 1,385            | 1,525             |
| Net income                                | \$ 4,024         | \$ 4,216          | \$ 4,509         | \$ 4,889          |
| Per Share Data:                           |                  |                   |                  |                   |
| Basic net income per common share         | \$ 0.58          | \$ 0.61           | \$ 0.65          | \$ 0.70           |
| Fully diluted net income per common share | 0.58             | 0.61              | 0.65             | 0.70              |
| Cash dividends per common share           | ---              | 0.48              | ---              | 0.52              |
| Book value per common share               | 19.27            | 19.65             | 20.44            | 20.36             |

|                                    | 2010          |                |               |                |
|------------------------------------|---------------|----------------|---------------|----------------|
|                                    | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Income Statement Data:             |               |                |               |                |
| Interest income                    | \$ 12,240     | \$ 12,347      | \$ 12,287     | \$ 12,265      |
| Interest expense                   | 2,979         | 2,850          | 2,726         | 2,603          |
| Net interest income                | 9,261         | 9,497          | 9,561         | 9,662          |
| Provision for loan losses          | 647           | 852            | 710           | 1,200          |
| Noninterest income                 | 1,971         | 2,123          | 2,101         | 2,152          |
| Noninterest expense                | 5,784         | 5,697          | 5,826         | 5,820          |
| Income taxes                       | 1,032         | 1,075          | 1,129         | 987            |
| Net income                         | \$ 3,769      | \$ 3,996       | \$ 3,997      | \$ 3,807       |
| Per Share Data:                    |               |                |               |                |
| Basic net income per share         | \$ 0.54       | \$ 0.58        | \$ 0.58       | \$ 0.55        |
| Fully diluted net income per share | 0.54          | 0.58           | 0.58          | 0.55           |
| Cash dividends per share           | ---           | 0.44           | ---           | 0.47           |
| Book value per share               | 18.25         | 18.44          | 19.13         | 18.63          |

## Balance Sheet

On December 31, 2012, the Company had total assets of \$1,104,361, an increase of \$37,259, or 3.49%, over the total of \$1,067,102 on December 31, 2011. For 2012, the growth in assets was entirely internally generated and was not the result of acquisitions. Total assets at December 31, 2011 were up by \$44,864, or 4.38%, over the total at December 31, 2010.

## Loans

The Company's loan categorization reflects its approach to loan portfolio management and includes six groups. Real estate construction loans include construction loans for residential and commercial properties, as well as land. Consumer real estate loans include conventional and junior lien mortgages as well as equity lines. Commercial real estate loans are comprised of owner-occupied and leased nonfarm, nonresidential properties, multi-family residence loans and farmland. Commercial non real estate loans include farm loans, operating capital lines and loans secured by capital assets. Public sector and IDA loans are extended to municipalities. Consumer non real estate loans include automobile loans, personal loans, credit cards and consumer overdrafts.

### A. Types of Loans

|  | December 31, |            |            |            |            |
|--|--------------|------------|------------|------------|------------|
|  | 2012         | 2011       | 2010       | 2009       | 2008       |
| Real estate construction               | \$ 50,313    | \$ 48,531  | \$ 46,169  | \$ 44,744  | \$ 60,798  |
| Consumer real estate                   | 143,262      | 150,224    | 153,405    | 154,380    | 152,482    |
| Commercial real estate                 | 304,308      | 303,192    | 293,171    | 293,229    | 277,511    |
| Commercial non real estate             | 37,349       | 38,832     | 37,547     | 41,402     | 36,978     |
| Public sector and IDA                  | 26,169       | 15,571     | 12,553     | 19,207     | 11,518     |
| Consumer non real estate               | 31,714       | 33,072     | 34,543     | 38,047     | 37,393     |
| Total loans                            | \$ 593,115   | \$ 589,422 | \$ 577,388 | \$ 591,009 | \$ 576,680 |
| Less unearned income and deferred fees | (953 )       | (952 )     | (945 )     | (1,062 )   | (1,123 )   |

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|                                     |            |            |            |            |            |
|-------------------------------------|------------|------------|------------|------------|------------|
| Total loans, net of unearned income | \$ 592,162 | \$ 588,470 | \$ 576,443 | \$ 589,947 | \$ 575,557 |
| Less allowance for loans losses     | (8,349 )   | (8,068 )   | (7,664 )   | (6,926 )   | (5,858 )   |
| Total loans, net                    | \$ 583,813 | \$ 580,402 | \$ 568,779 | \$ 583,021 | \$ 569,699 |

## B. Maturities and Interest Rate Sensitivities

The following table presents maturities and interest rate sensitivities for commercial non real estate, commercial real estate and real estate construction loans.

|  | December 31, 2012 |             |                  |            |
|--|-------------------|-------------|------------------|------------|
|  | < 1 Year          | 1 – 5 Years | After 5<br>Years | Total      |
| Commercial non real estate                   | \$ 19,872         | \$ 14,296   | \$ 3,181         | \$ 37,349  |
| Commercial real estate                       | 41,481            | 250,765     | 12,062           | 304,308    |
| Real estate construction                     | 48,106            | 2,207       | ---              | 50,313     |
| Total  | 109,459           | 267,268     | 15,243           | 391,970    |
| Less loans with predetermined interest rates | (24,915 )         | (23,734 )   | (6,694 )         | (55,343 )  |
| Loans with adjustable rates                  | \$ 84,544         | \$ 243,534  | \$ 8,549         | \$ 336,627 |

## C. Risk Elements

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

|  | December 31, |          |          |          |          |
|--|--------------|----------|----------|----------|----------|
|  | 2012         | 2011     | 2010     | 2009     | 2008     |
| Nonaccrual loans:                            |              |          |          |          |          |
| Real estate construction                     | \$ 89        | \$ ---   | \$ ---   | \$ 2,643 | \$ ---   |
| Consumer real estate                         | 612          | 296      | 964      | ---      | ---      |
| Commercial real estate                       | 2,736        | 702      | 526      | 1,455    | 1,333    |
| Commercial non real estate                   | 26           | 400      | 448      | ---      | ---      |
| Public sector and IDA                        | ---          | ---      | ---      | ---      | ---      |
| Consumer non real estate                     | 3            | ---      | ---      | ---      | ---      |
| Total nonaccrual loans                       | \$ 3,466     | \$ 1,398 | \$ 1,938 | \$ 4,098 | \$ 1,333 |
| Restructured loans (TDR Loans) in nonaccrual |              |          |          |          |          |
| Real estate construction                     | \$ 123       | \$ 1,681 | \$ 2,185 | \$ ---   | \$ ---   |
| Consumer real estate                         | 407          | 315      | ---      | ---      | ---      |
| Commercial real estate                       | 1,142        | 1,544    | 3,698    | ---      | ---      |
| Commercial non real estate                   | 479          | 198      | 250      | ---      | ---      |
| Public sector and IDA                        | ---          | ---      | ---      | ---      | ---      |
| Consumer non real estate                     | ---          | 68       | ---      | ---      | ---      |
| Total restructured loans in nonaccrual       | 2,151        | 3,806    | 6,133    | ---      | ---      |
| Total nonperforming loans                    | \$ 5,617     | \$ 5,204 | \$ 8,071 | \$ 4,098 | \$ 1,333 |
| Other real estate owned, net                 | 1,435        | 1,489    | 1,723    | 2,126    | 1,984    |
| Total nonperforming assets                   | \$ 7,052     | \$ 6,693 | \$ 9,794 | \$ 6,224 | \$ 3,317 |
| Accruing loans past due 90 days or more:     |              |          |          |          |          |
| Real estate construction                     | \$ ---       | \$ ---   | \$ ---   | \$ 20    | \$ ---   |
| Consumer real estate                         | 156          | 346      | 612      | 873      | 394      |
| Commercial real estate                       | ---          | 63       | 577      | 643      | 589      |
| Commercial non real estate                   | ---          | 26       | 81       | 99       | 74       |
| Public sector and IDA                        | ---          | ---      | ---      | ---      | ---      |
| Consumer non real estate                     | 14           | 46       | 66       | 62       | 70       |
|  | \$ 170       | \$ 481   | \$ 1,336 | \$ 1,697 | \$ 1,127 |
| Accruing restructured loans:                 |              |          |          |          |          |
| Real estate construction                     | \$ ---       | \$ 1,611 | \$ ---   | \$ ---   | \$ ---   |
| Consumer real estate                         | 80           | 156      | ---      | ---      | ---      |
| Commercial real estate                       | 1,886        | 1,922    | 350      | 2,652    | ---      |
| Commercial non real estate                   | 39           | 67       | ---      | ---      | ---      |
| Public sector and IDA                        | ---          | ---      | ---      | ---      | ---      |
| Consumer non real estate                     | ---          | ---      | ---      | ---      | ---      |
|  | \$ 2,005     | \$ 3,756 | \$ 350   | \$ 2,652 | \$ ---   |





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

#### Loan Loss Data Table

|   | 2012 |        | 2011 |        | 2010 |       |
|---|------|--------|------|--------|------|-------|
| Provision for loan losses   | \$   | 3,134  | \$   | 2,949  | \$   | 3,409 |
| Net charge-offs to average net loans  |      | 0.49   | %    | 0.43   | %    | 0.46  |
| Allowance for loan losses to loans, net of unearned income and deferred fees                          |      | 1.41   | %    | 1.37   | %    | 1.33  |
| Allowance for loan losses to nonperforming loans  |      | 148.64 | %    | 155.03 | %    | 94.96 |
| Allowance for loan losses to nonperforming assets   |      | 118.39 | %    | 120.54 | %    | 78.25 |
| Nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned |      | 1.19   | %    | 1.13   | %    | 1.69  |
| Nonaccrual loans  | \$   | 3,466  | \$   | 1,398  | \$   | 1,938 |
| Restructured loans in nonaccrual status   |      | 2,151  |      | 3,806  |      | 6,133 |
| Other real estate owned, net  |      | 1,435  |      | 1,489  |      | 1,723 |
| Total nonperforming assets  | \$   | 7,052  | \$   | 6,693  | \$   | 9,794 |
| Accruing loans past due 90 days or more   | \$   | 170    | \$   | 481    | \$   | 1,336 |

Nonperforming loans include nonaccrual loans and restructured loans (“troubled debt restructurings” or “TDR loans”) in nonaccrual status, but do not include accruing loans 90 days or more past due or accruing restructured loans. Troubled debt restructurings are discussed in detail under the section titled “D. Troubled Debt Restructurings (TDR Loans)” below. Impaired loans, or loans for which management does not expect to collect at the original loan terms, but which may or may not be nonperforming, are presented in Note 5 of Notes to Consolidated Financial Statements. Total impaired loans at December 31, 2012 were \$11,053, of which \$4,417 were in nonaccrual status. Impaired loans at December 31, 2011 and 2010 were \$12,596 and \$8,791, of which \$5,089 and \$7,612 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans decreased from 155.03% in 2011 to 148.64% in 2012. The 5.36% increase in nonperforming assets resulted in the decline in the coverage of the allowance for loan losses to nonperforming assets. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

#### D. Troubled Debt Restructurings (TDR Loans)

In the ordinary course of business the Company modifies loan terms on a case-by-case basis, including both consumer and commercial loans, for a variety of reasons. Modifications to consumer loans generally involve short-term deferrals to accommodate specific, temporary circumstances. The Company may grant extensions to borrowers who have demonstrated a willingness and ability to repay their loan but who are dealing with the consequences of a specific unforeseen temporary hardship.

An extension defers monthly payments and requires a balloon payment at the original contractual maturity. Where the temporary event is not expected to impact a borrower’s ability to repay the debt, and where the Company expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay at contractual maturity, the modification is not designated a TDR.

Modifications to commercial loans may include, but are not limited to, changes in interest rate, maturity, amortization and financial covenants. In the original underwriting, loan terms are established that represent the then-current and projected financial condition of the borrower. If the modified terms are consistent with competitive market conditions and representative of terms the borrower could otherwise obtain in the open market, the modified loan is not categorized as a TDR.

For a loan modification to be a TDR, the following three conditions must all be present: (1) the borrower is experiencing financial difficulty, (2) the Company makes a concession to the original contractual loan terms, and (3) the concessions are for economic or legal reasons related to the borrower's financial difficulty that the Company would not otherwise consider.

Modifications of loan terms to borrowers experiencing financial difficulty are made in an attempt to protect as much of the Company's investment in the loan as possible. The determination of whether a modification should be accounted for as a TDR requires significant judgment after consideration of all facts and circumstances surrounding the transaction.

Assuming all other TDR criteria are met, the Corporation considers one or a combination of the following concessions to the loan terms to indicate TDR status: a reduction of the stated interest rate, an extension of the maturity date at an interest rate lower than the current market rate for a new loan with a similar term, or forgiveness of principal or accrued interest.

The Company recognizes that the current economy, elevated levels of unemployment and depressed real estate values have resulted in many customers experiencing financial difficulties. The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure.

The Company had \$4,156 in TDRs as of December 31, 2012 and \$7,562 as of December 31, 2011. Accruing TDR loans amounted to \$2,005 at December 31, 2012 compared to \$3,756 at December 31, 2011. All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans with an impairment loss are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

Restructuring generally results in loans with either lower payments or an extended maturity beyond that originally required, and are expected to have a lower risk of loss due to nonperformance than loans classified as nonperforming. In 2012, the Company modified \$1,736 in troubled debt restructurings. Of these, \$1,426 subsequently defaulted. The Company defines default as a delay in one payment of more than 90 days. In 2011, the Company modified \$2,999 in troubled debt restructurings, of which \$2,852 defaulted in 2011. In 2010, the Company modified \$3,787 in troubled debt restructurings, of which \$1,776 defaulted in 2010. Please refer to Note 5 for information on the effect of default on the allowance for loan losses.

## TDR Delinquency Status as of December 31, 2012

|                            | Total TDR<br>Loans | Current  | Accruing<br>30-89<br>Days Past<br>Due | 90+ Days<br>Past Due | Nonaccrual |
|----------------------------|--------------------|----------|---------------------------------------|----------------------|------------|
| Real estate construction   | \$ 123             | \$ ---   | \$ ---                                | \$ ---               | \$ 123     |
| Consumer real estate       | 487                | 80       | ---                                   | ---                  | 407        |
| Commercial real estate     | 3,028              | 1,886    | ---                                   | ---                  | 1,142      |
| Commercial non real estate | 518                | 39       | ---                                   | ---                  | 479        |
| Public sector and IDA      | ---                | ---      | ---                                   | ---                  | ---        |
| Consumer non real estate   | ---                | ---      | ---                                   | ---                  | ---        |
| Total TDR Loans            | \$ 4,156           | \$ 2,005 | \$ ---                                | \$ ---               | \$ 2,151   |

## TDR Delinquency Status as of December 31, 2011

|                            | Total TDR<br>Loans | Current  | Accruing<br>30-89<br>Days Past<br>Due | 90+ Days<br>Past Due | Nonaccrual |
|----------------------------|--------------------|----------|---------------------------------------|----------------------|------------|
| Real estate construction   | \$ 3,292           | \$ 1,611 | \$ ---                                | \$ ---               | \$ 1,681   |
| Consumer real estate       | 471                | 156      | ---                                   | ---                  | 315        |
| Commercial real estate     | 3,466              | 1,922    | ---                                   | ---                  | 1,544      |
| Commercial non real estate | 265                | 67       | ---                                   | ---                  | 198        |
| Public sector and IDA      | ---                | ---      | ---                                   | ---                  | ---        |
| Consumer non real estate   | 68                 | ---      | ---                                   | ---                  | 68         |
| Total TDR Loans            | \$ 7,562           | \$ 3,756 | \$ ---                                | \$ ---               | \$ 3,806   |

## TDR Delinquency Status as of December 31, 2010

|  | Total TDR<br>Loans | Current | Accruing<br>30-89<br>Days Past | 90+ Days<br>Past Due | Nonaccrual |
|--|--------------------|---------|--------------------------------|----------------------|------------|
|--|--------------------|---------|--------------------------------|----------------------|------------|

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|                            |          |        | Due    |        |          |
|----------------------------|----------|--------|--------|--------|----------|
| Real estate construction   | \$ 2,185 | \$ --- | \$ --- | \$ --- | \$ 2,185 |
| Consumer real estate       | ---      | ---    | ---    | ---    | ---      |
| Commercial real estate     | 4,048    | 350    | ---    | ---    | 3,698    |
| Commercial non real estate | 250      | ---    | ---    | ---    | 250      |
| Public sector and IDA      | ---      | ---    | ---    | ---    | ---      |
| Consumer non real estate   | ---      | ---    | ---    | ---    | ---      |
| Total TDR Loans            | \$ 6,483 | \$ 350 | \$ --- | \$ --- | \$ 6,133 |

The Company expects that troubled debt restructurings will continue until the economy recovers, bringing improvement in the unemployment rate and the depressed real estate market.

### 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:

|  | December 31, |         |      |         |      |         |      |         |      |         |   |
|--|--------------|---------|------|---------|------|---------|------|---------|------|---------|---|
|  | 2012         |         | 2011 |         | 2010 |         | 2009 |         | 2008 |         |   |
| Average net loans outstanding                    | \$           | 588,170 | \$   | 588,439 | \$   | 586,133 | \$   | 579,581 | \$   | 538,868 |   |
| Balance at beginning of year                     |              | 8,068   |      | 7,664   |      | 6,926   |      | 5,858   |      | 5,219   |   |
| Charge-offs:                                     |              |         |      |         |      |         |      |         |      |         |   |
| Real estate construction                         |              | 640     |      | 444     |      | ---     |      | ---     |      | ---     |   |
| Consumer real estate                             |              | 370     |      | 584     |      | 475     |      | 181     |      | 35      |   |
| Commercial real estate                           |              | 1,589   |      | 320     |      | 1,050   |      | ---     |      | 82      |   |
| Commercial non real estate                       |              | 109     |      | 990     |      | 919     |      | 83      |      | 64      |   |
| Public Sector and IDA                            |              | ---     |      | ---     |      | ---     |      | ---     |      | ---     |   |
| Consumer non real estate                         |              | 245     |      | 290     |      | 366     |      | 383     |      | 430     |   |
| Total loans charged off                          |              | 2,953   |      | 2,628   |      | 2,810   |      | 647     |      | 611     |   |
| Recoveries:                                      |              |         |      |         |      |         |      |         |      |         |   |
| Real estate construction                         |              | 13      |      | ---     |      | ---     |      | ---     |      | ---     |   |
| Consumer real estate                             |              | 8       |      | 16      |      | 10      |      | 16      |      | 2       |   |
| Commercial real estate                           |              | ---     |      | ---     |      | 61      |      | ---     |      | 28      |   |
| Commercial non real estate                       |              | 2       |      | ---     |      | 1       |      | 3       |      | 9       |   |
| Public Sector and IDA                            |              | ---     |      | ---     |      | ---     |      | ---     |      | ---     |   |
| Consumer non real estate                         |              | 77      |      | 67      |      | 67      |      | 62      |      | 92      |   |
| Total recoveries                                 |              | 100     |      | 83      |      | 139     |      | 81      |      | 131     |   |
| Net loans charged off                            |              | 2,853   |      | 2,545   |      | 2,671   |      | 566     |      | 480     |   |
| Additions charged to operations                  |              | 3,134   |      | 2,949   |      | 3,409   |      | 1,634   |      | 1,119   |   |
| Balance at end of year                           | \$           | 8,349   | \$   | 8,068   | \$   | 7,664   | \$   | 6,926   | \$   | 5,858   |   |
| Net charge-offs to average net loans outstanding |              | 0.49    | %    | 0.43    | %    | 0.46    | %    | 0.10    | %    | 0.09    | % |

The Company charges off commercial real estate loans at the time that a loss is confirmed. When delinquency status or other information indicates that the borrower will not repay the loan, the Company considers collateral value based upon a current appraisal. Any loan amount in excess of collateral value is charged off and the collateral is taken into other real estate owned.

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 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:

|                            | 2012  |             | 2011  |             | December 31, 2010                                     |             | 2009  |             | 2008  |             |
|----------------------------|---|-------------|---|-------------|---|-------------|---|-------------|---|-------------|
|                            | Percent of Loans in Each Category to Allowance Amount | Total Loans | Percent of Loans in Each Category to Allowance Amount | Total Loans | Percent of Loans in Each Category to Allowance Amount | Total Loans | Percent of Loans in Each Category to Allowance Amount | Total Loans | Percent of Loans in Each Category to Allowance Amount | Total Loans |
| Real estate construction   | \$ 1,175  | 8.48%       | \$1,079   | 8.23%       | \$1,087   | 8.00%       | \$1,917   | 7.57%       | \$ 468  | 10.54%      |
| Consumer real estate       | 2,263   | 24.15%      | 1,245   | 25.49%      | 1,052   | 26.57%      | 330   | 26.12%      | 874   | 26.44%      |
| Commercial real estate     | 3,315   | 51.31%      | 3,515   | 51.44%      | 3,461   | 50.78%      | 2,654   | 49.61%      | 2,566   | 48.12%      |
| Commercial non real estate | 956   | 6.30%       | 1,473   | 6.59%       | 1,089   | 6.50%       | 1,148   | 7.01%       | 1,035   | 6.41%       |
| Public sector and IDA      | 142   | 4.41%       | 232   | 2.64%       | 259   | 2.17%       | 84  | 3.25%       | 93  | 2.00%       |
| Consumer non real estate   | 417   | 5.35%       | 403   | 5.61%       | 587   | 5.98%       | 507   | 6.44%       | 700   | 6.49%       |
| Unallocated                | 81  |             | 121   |             | 129   |             | 286   |             | 122   |             |
|                            | \$ 8,349  | 100.00%     | \$8,068   | 100.00%     | \$7,664   | 100.00%     | \$6,926   | 100.00%     | \$5,858   | 100.00%     |

An analysis of the allowance for loan losses by impairment basis follows:

|   | 2012      |   | December 31, 2011 |   | 2010     |   |
|---|-----------|---|-------------------|---|----------|---|
|   | Amount    | % | Amount            | % | Amount   | % |
| Impaired loans  | \$ 11,053 |   | \$ 12,596         |   | \$ 8,791 |   |
| Allowance related to impaired loans                   | 269       |   | 1,123             |   | 1,200    |   |
| Allowance to impaired loans                           | 2.43      | % | 8.92              | % | 13.65    | % |
| Non-impaired loans                                    | 582,062   |   | 575,874           |   | 567,652  |   |
| Allowance related to non-impaired loans               | 8,080     |   | 6,945             |   | 6,464    |   |
| Allowance to non-impaired loans                       | 1.39      | % | 1.21              | % | 1.14     | % |
| Total loans, net of unearned income and deferred fees | 592,162   |   | 588,470           |   | 576,443  |   |
| Total allowance for loan losses                       | 8,349     |   | 8,068             |   | 7,664    |   |
| Total allowance for total loans                       | 1.41      | % | 1.37              | % | 1.33     | % |

The allowance percentage for impaired loans was 2.43%, 8.92% and 13.65% as of December 31, 2012, 2011 and 2010 respectively. The ratio is subject to fluctuation because impaired loans are individually evaluated. The amount of the

individual impaired loan balances that exceeds the fair value is accrued in the allowance for loan losses.

The allowance percentage for non-impaired loans was 1.39%, 1.21% 1.14% as of December 31, 2012, 2011 and 2010 respectively. The allowance for non-impaired loans is determined by applying historical charge-off percentages, as well as additional accruals for internal and external credit risk factors to groups of non-impaired loans. The ratio increased from prior years because of increased historical charge-off percentages applied by the 2012 calculation and higher risk indications from other factors. The increase in the ratio for non-impaired loans directed the increase in the ratio of total allowance to total loans.



## Securities

The fair value of securities available for sale was \$191,504, an increase of \$16,586 or 9.48% from December 31, 2011. The amortized cost of securities held to maturity was \$160,539 at December 31, 2012 and \$143,995 at December 31, 2011, an increase of \$16,544 or 11.49%. Both categories of securities increased in 2012, as liquidity from deposit growth outpaced loan opportunities.

Additional information about securities available for sale and securities held to maturity can be found in Note 3 of the Notes to Consolidated Financial Statements.

The financial markets have experienced increased volatility and increased risk during the economic downturn and slow recovery. The risk in financial markets affects the Company in the same way that it affects other institutional and individual investors. The Company's investment portfolio includes corporate bonds. If, because of economic hardship, the corporate issuers were to default, there could be a delay in the payment of interest, or there could be a loss of principal and accrued interest. To date, there have been no defaults in any of the corporate bonds held in the portfolio. The Company's investment portfolio also contains a large percentage of municipal bonds. The recession and a slow recovery may negatively impact the ability of states and municipalities to make scheduled principal and interest payments on their outstanding indebtedness. If their income from taxes and other sources declines significantly because of the recession, states and municipalities could default on their bond obligations. The risk is at this point hypothetical, because there have been no defaults among the municipal bonds in the Company's investment portfolio. In making investment decisions, management follows internal policy guidelines that help to limit risk by specifying parameters for both security quality and industry and geographic concentrations. Management regularly monitors the quality of the investment portfolio and tracks changes in financial markets. The value of individual securities will be written down if a decline in fair value is considered to be other than temporary, given the totality of the circumstances.

## 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, 2012 and weighted average yield for each range of maturities.

| \$ in thousands,<br>except percent data           | Maturities and Yields |                  |                  |                   |                 |                   |            |        |        |          |       |
|---|-----------------------|------------------|------------------|-------------------|-----------------|-------------------|------------|--------|--------|----------|-------|
|   | December 31, 2012     |                  |                  |                   |                 |                   |            |        |        |          |       |
|   | < 1 Year              |                  | 1-5 Years        |                   | 5-10 Years      |                   | > 10 Years |        | None   |          | Total |
| <b>Available for Sale:</b>                        |                       |                  |                  |                   |                 |                   |            |        |        |          |       |
| U.S. Treasury                                     | \$ 2,073              | \$ ---           | \$ ---           | \$ ---            | \$ ---          | \$ ---            | \$ ---     | \$ --- | \$ --- | \$ 2,073 |       |
|   | 3.97 %                | ---              | ---              | ---               | ---             | ---               | ---        | ---    | ---    | 3.97 %   |       |
| U.S. Government agencies                          | 1,007                 | 1,051            | 2,180            | 125,326           | ---             | ---               | ---        | ---    | ---    | 129,564  |       |
|   | 4.75 %                | 4.44 %           | 3.18 %           | 3.38 %            | ---             | ---               | ---        | ---    | ---    | 3.40 %   |       |
| Mortgage-backed securities                        | 139                   | 958              | 1,244            | 2,228             | ---             | ---               | ---        | ---    | ---    | 4,569    |       |
|   | 4.45 %                | 5.17 %           | 4.96 %           | 5.36 %            | ---             | ---               | ---        | ---    | ---    | 5.18 %   |       |
| States and political subdivision – nontaxable (1) | 6,515                 | 8,603            | 9,451            | 12,210            | ---             | ---               | ---        | ---    | ---    | 36,779   |       |
|   | 5.29 %                | 5.74 %           | 5.66 %           | 5.77 %            | ---             | ---               | ---        | ---    | ---    | 5.65 %   |       |
| Corporate   | 6,471                 | 1,937            | ---              | 6,167             | ---             | ---               | ---        | ---    | ---    | 14,575   |       |
|   | 4.40 %                | 4.90 %           | ---              | 4.13 %            | ---             | ---               | ---        | ---    | ---    | 4.35 %   |       |
| Federal Home Loan Bank stock                      | ---                   | ---              | ---              | ---               | ---             | ---               | ---        | 1,597  | ---    | 1,597    |       |
|   | ---                   | ---              | ---              | ---               | ---             | ---               | ---        | 0.01 % | ---    | 0.01 %   |       |
| Federal Reserve Bank stock                        | ---                   | ---              | ---              | ---               | ---             | ---               | ---        | 92     | ---    | 92       |       |
|   | ---                   | ---              | ---              | ---               | ---             | ---               | ---        | 6.00 % | ---    | 6.00 %   |       |
| Other securities                                  | 688                   | ---              | ---              | ---               | ---             | ---               | ---        | 1,567  | ---    | 2,255    |       |
|   | 0.16 %                | ---              | ---              | ---               | ---             | ---               | ---        | 0.70 % | ---    | 0.53 %   |       |
| <b>Total</b>                                      | <b>\$ 16,893</b>      | <b>\$ 12,549</b> | <b>\$ 12,875</b> | <b>\$ 145,931</b> | <b>\$ 3,256</b> | <b>\$ 191,504</b> |            |        |        |          |       |
|   | 4.54 %                | 5.46 %           | 5.17 %           | 3.64 %            | 0.51 %          | 3.89 %            |            |        |        |          |       |
| <b>Held to Maturity:</b>                          |                       |                  |                  |                   |                 |                   |            |        |        |          |       |
| U.S. Government agencies                          | \$ ---                | \$ ---           | \$ 3,056         | \$ 4,932          | \$ ---          | \$ 7,988          |            |        |        |          |       |
|   | ---                   | ---              | 4.17 %           | 3.66 %            | ---             | 3.86 %            |            |        |        |          |       |
| Mortgage-backed securities                        | ---                   | ---              | ---              | 691               | ---             | 691               |            |        |        |          |       |
|   | ---                   | ---              | ---              | 5.55 %            | ---             | 5.55 %            |            |        |        |          |       |
| States and political subdivision – nontaxable (1) | 3,256                 | 8,537            | 10,689           | 128,727           | ---             | 151,209           |            |        |        |          |       |
|   | 6.77 %                | 6.05 %           | 5.43 %           | 5.48 %            | ---             | 5.54 %            |            |        |        |          |       |
| Corporate   | 651                   | ---              | ---              | ---               | ---             | 651               |            |        |        |          |       |
|   | 3.95 %                | ---              | ---              | ---               | ---             | 3.95 %            |            |        |        |          |       |

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|       |          |          |           |            |        |            |
|-------|----------|----------|-----------|------------|--------|------------|
| Total | \$ 3,907 | \$ 8,537 | \$ 13,745 | \$ 134,350 | \$ --- | \$ 160,539 |
|       | 6.30 %   | 6.05 %   | 5.15 %    | 5.41 %     | ---    | 5.45 %     |

(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, 2012 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Federal 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 that 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.

Deposits

Total deposits increased by \$27,433, or 2.98%, from \$919,333 at December 31, 2011 to \$946,766 at December 31, 2012. Total deposits grew \$34,750, or 3.93%, from \$884,583 at December 31, 2010 to December 31, 2011. A portion of the increase in both 2012 and 2011 is attributable to a higher level of municipal deposits. The increases in total deposits for 2012 and 2011 were internally generated and not the result of acquisitions.

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

Average amounts and average rates paid on deposit categories are presented below:

|                                     | Year Ended December 31, |                          |                    |                          |                    |                          |
|-------------------------------------|-------------------------|--------------------------|--------------------|--------------------------|--------------------|--------------------------|
|                                     | 2012                    |                          | 2011               |                          | 2010               |                          |
|                                     | Average<br>Amounts      | Average<br>Rates<br>Paid | Average<br>Amounts | Average<br>Rates<br>Paid | Average<br>Amounts | Average<br>Rates<br>Paid |
| Noninterest-bearing demand deposits | \$ 141,269              | ---                      | \$ 135,880         | ---                      | \$ 122,817         | ---                      |
| Interest-bearing demand deposits    | 420,947                 | 0.99%                    | 378,971            | 1.08%                    | 322,705            | 1.03%                    |
| Savings deposits                    | 64,973                  | 0.06%                    | 58,273             | 0.08%                    | 54,543             | 0.09%                    |
| Time deposits                       | 298,797                 | 1.23%                    | 314,920            | 1.60%                    | 352,888            | 2.20%                    |
| Average total deposits              | \$ 925,986              | 1.01%                    | \$ 888,044         | 1.22%                    | \$ 852,953         | 1.53%                    |

## 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:

|  | December 31, 2012   |   |  |                   |            | Total |
|--|---------------------|---|--|-------------------|------------|-------|
|  | 3 Months or<br>Less | Over 3<br>Months<br>Through 6<br>Months | Over 6<br>Months<br>Through 12<br>Months | Over 12<br>Months |            |       |
| Total time deposits of \$100,000 or more | \$ 29,259           | \$ 24,097                               | \$ 41,312                                | \$ 17,577         | \$ 112,245 |       |

## 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 GNMA's and FNMA's, with a fair value of approximately \$5,335. See Note 3 of Notes to Consolidated Financial Statements for additional information relating to securities.

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, securities have been sold 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 in the foreseeable future, though it does remain an option.

While the asset/liability planning program 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 negatively affected in a period of rapidly rising or rapidly falling rates, because it takes some time for the Company to change its rates to adjust to a new interest rate environment. 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 meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At December 31, 2012, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

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

Regulatory capital levels determine the Company's ability to use purchased deposits and the Federal Reserve discount window. At December 31, 2012, the Company is considered well capitalized and does not have any restrictions on purchased deposits or the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At December 31, 2012, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At December 31, 2012, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At December 31, 2012, the loan to deposit ratio was 62.55%, slightly below policy levels. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

## Recent Accounting Pronouncements

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

## Capital Resources

Total stockholders' equity at December 31, 2012 was \$150,109, an increase of \$8,810, or 6.24%, from the \$141,299 at December 31, 2011. The largest component of 2012 stockholders' equity was retained earnings of \$144,162, which included net income of \$17,747, offset by dividends of \$7,639. Exercised stock options provided \$119 in 2012.

Total stockholders' equity grew by \$12,112 or 9.38%, from \$129,187 on December 31, 2010 to \$141,299 on December 31, 2011. Earnings, net of the change in unrealized gains and losses for securities available for sale and dividends paid, accounted for most of the increase in 2011.

The Tier I and Tier II risk-based capital ratios at December 31, 2012 were 21.20% and 22.4%, respectively. Capital ratios are significantly above the regulatory minimum requirements of 4% for Tier I and 8% for Tier II. The Tier I and Tier II risk-based capital ratios at December 31, 2011 were 19.7% and 20.9%, respectively.

## Off-Balance Sheet Arrangements

The Company's off-balance sheet arrangements at December 31, 2012 are detailed in the table below.

|   | Payments Due by Period |                     |           |           |                         |
|---|------------------------|---------------------|-----------|-----------|-------------------------|
|   | Total                  | Less Than 1<br>Year | 1-3 Years | 3-5 Years | More<br>Than 5<br>Years |
| Commitments to extend credit              | \$ 128,162             | \$ 128,162          | \$ ---    | \$ ---    | \$ ---                  |
| Standby letters of credit                 | 12,533                 | 12,533              | ---       | ---       | ---                     |
| Mortgage loans with potential<br>recourse | 22,574                 | 22,574              | ---       | ---       | ---                     |
| Operating leases                          | 478                    | 219                 | 237       | 22        | ---                     |
| Total                                     | \$ 163,747             | \$ 163,488          | \$ 237    | \$ 22     | \$ ---                  |

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 \$56 in 2012.

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 or investments would also be an option.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. The mortgages originated must meet strict underwriting and documentation requirements for the sale to be completed. The Company estimates a potential loss reserve for recourse provisions. The amount is not material as of December 31, 2012. To date, no recourse provisions have been invoked.

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

#### 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.



## Item 8. Financial Statements and Supplementary Data

## Consolidated Balance Sheets

| \$ in thousands, except per share data  | December 31, |              |
|---|--------------|--------------|
|   | 2012         | 2011         |
| <b>Assets</b>   |              |              |
| Cash and due from banks   | \$ 14,783    | \$ 11,897    |
| Interest-bearing deposits   | 96,597       | 98,355       |
| Securities available for sale, at fair value  | 191,504      | 174,918      |
| Securities held to maturity (fair value approximates \$170,846 at December 31, 2012 and \$151,429 at December 31, 2011) | 160,539      | 143,995      |
| Mortgage loans held for sale  | 2,796        | 2,623        |
| <b>Loans:</b>   |              |              |
| Real estate construction loans  | 50,313       | 48,531       |
| Consumer real estate loans  | 143,262      | 150,224      |
| Commercial real estate loans  | 304,308      | 303,192      |
| Commercial non real estate loans  | 37,349       | 38,832       |
| Public sector and IDA loans   | 26,169       | 15,571       |
| Consumer non real estate loans  | 31,714       | 33,072       |
| Total loans   | 593,115      | 589,422      |
| Less unearned income and deferred fees  | (953 )       | (952 )       |
| Loans, net of unearned income and deferred fees   | 592,162      | 588,470      |
| Less allowance for loan losses  | (8,349 )     | (8,068 )     |
| Loans, net  | 583,813      | 580,402      |
| Premises and equipment, net   | 10,401       | 10,393       |
| Accrued interest receivable   | 6,247        | 6,304        |
| Other real estate owned, net  | 1,435        | 1,489        |
| Intangible assets and goodwill  | 9,377        | 10,460       |
| Bank-owned life insurance   | 20,523       | 19,812       |
| Other assets  | 6,346        | 6,454        |
| Total assets  | \$ 1,104,361 | \$ 1,067,102 |
| <b>Liabilities and Stockholders' Equity</b>   |              |              |
| Noninterest-bearing demand deposits   | \$ 144,252   | \$ 142,163   |
| Interest-bearing demand deposits  | 455,713      | 404,801      |
| Savings deposits  | 69,063       | 61,298       |
| Time deposits   | 277,738      | 311,071      |
| Total deposits  | 946,766      | 919,333      |
| Accrued interest payable  | 139          | 206          |
| Other liabilities   | 7,347        | 6,264        |
| Total liabilities   | 954,252      | 925,803      |
| Commitments and contingencies   | ---          | ---          |
| <b>Stockholders' equity:</b>  |              |              |
| Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding                                 | ---          | ---          |
|   | 8,685        | 8,675        |

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Common stock of \$1.25 par value. Authorized 10,000,000 shares; issued and outstanding, 6,947,974 shares in 2012 and 6,939,974 shares in 2011

|   |              |              |
|---|--------------|--------------|
| Retained earnings                           | 144,162      | 133,945      |
| Accumulated other comprehensive (loss), net | (2,738 )     | (1,321 )     |
| Total stockholders' equity                  | 150,109      | 141,299      |
| Total liabilities and stockholders' equity  | \$ 1,104,361 | \$ 1,067,102 |

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

## Consolidated Statements of Income

| \$ in thousands, except per share data              | Years ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2012                     | 2011      | 2010      |
| <b>Interest Income</b>                              |                          |           |           |
| Interest and fees on loans                          | \$ 35,354                | \$ 36,514 | \$ 36,919 |
| Interest on interest-bearing deposits               | 240                      | 155       | 128       |
| Interest on securities – taxable                    | 6,613                    | 6,745     | 5,588     |
| Interest on securities – nontaxable                 | 6,463                    | 6,532     | 6,504     |
| Total interest income                               | 48,670                   | 49,946    | 49,139    |
| <b>Interest Expense</b>                             |                          |           |           |
| Interest on time deposits of \$100,000 or more      | 1,491                    | 2,019     | 3,439     |
| Interest on other deposits                          | 6,396                    | 7,165     | 7,719     |
| Total interest expense                              | 7,887                    | 9,184     | 11,158    |
| Net interest income                                 | 40,783                   | 40,762    | 37,981    |
| Provision for loan losses                           | 3,134                    | 2,949     | 3,409     |
| Net interest income after provision for loan losses | 37,649                   | 37,813    | 34,572    |
| <b>Noninterest Income</b>                           |                          |           |           |
| Service charges on deposit accounts                 | 2,594                    | 2,617     | 2,858     |
| Other service charges and fees                      | 243                      | 287       | 317       |
| Credit card fees                                    | 3,278                    | 3,197     | 2,954     |
| Trust income  | 1,313                    | 1,087     | 1,118     |
| BOLI income   | 814                      | 762       | 760       |
| Other income  | 472                      | 449       | 354       |
| Realized securities gains (losses), net             | 25                       | 11        | (14 )     |
| Total noninterest income                            | 8,739                    | 8,410     | 8,347     |
| <b>Noninterest Expense</b>                          |                          |           |           |
| Salaries and employee benefits                      | 12,005                   | 11,357    | 10,963    |
| Occupancy, furniture and fixtures                   | 1,589                    | 1,599     | 1,875     |
| Data processing and ATM                             | 1,593                    | 1,701     | 1,499     |
| FDIC assessment                                     | 475                      | 677       | 1,080     |
| Credit card processing                              | 2,442                    | 2,485     | 2,300     |
| Intangible assets amortization                      | 1,083                    | 1,083     | 1,083     |
| Net costs of other real estate owned                | 208                      | 518       | 214       |
| Franchise taxes                                     | 901                      | 780       | 963       |
| Other operating expenses                            | 3,100                    | 3,138     | 3,150     |
| Total noninterest expense                           | 23,396                   | 23,338    | 23,127    |
| Income before income taxes                          | 22,992                   | 22,885    | 19,792    |
| Income tax expense                                  | 5,245                    | 5,247     | 4,223     |
| Net income  | \$ 17,747                | \$ 17,638 | \$ 15,569 |
| Basic net income per common share                   | \$ 2.56                  | \$ 2.54   | \$ 2.25   |
| Fully diluted net income per common share           | \$ 2.55                  | \$ 2.54   | \$ 2.24   |

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



## Consolidated Statements of Comprehensive Income

| \$ in thousands, except per share data  | Years ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2012                     | 2011      | 2010      |
| Net Income  | \$ 17,747                | \$ 17,638 | \$ 15,569 |
| <b>Other Comprehensive Income, Net of Tax</b>   |                          |           |           |
| Unrealized holding gains (losses) on available for sale securities net of taxes of (\$320) in 2012, \$1,468 in 2011 and (\$923) in 2010           | (592 )                   | 2,725     | (1,716 )  |
| Reclassification adjustment for gains included in net income, net of taxes of (\$3) in 2012, \$9 in 2011 and (\$7) in 2010                        | (7 )                     | 17        | (12 )     |
| Net pension loss arising during the period, net of taxes of (\$405) in 2012, (\$731) in 2011, and (\$188) in 2010                                 | (752 )                   | (1,356 )  | (348 )    |
| Less amortization of prior service cost included in net periodic pension cost, net of taxes of (\$35) in 2012, (\$35) in 2011, and (\$39) in 2010 | (66 )                    | (66 )     | (73 )     |
| Other comprehensive income (loss), net of taxes of (\$763) in 2012, \$711 in 2011 and (\$1,157) in 2010   | (1,417 )                 | 1,320     | (2,149 )  |
| Total Comprehensive Income  | \$ 16,330                | \$ 18,958 | \$ 13,420 |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Changes in Stockholders' Equity

| \$ in thousands, except per share data            | Common Stock | Retained Earnings | Accumulated Other Comprehensive (Loss) | Total      |
|---|--------------|-------------------|--|------------|
| Balance at December 31, 2009                      | \$ 8,667     | \$ 113,901        | \$ (492)                               | \$ 122,076 |
| Net income  | ---          | 15,569            | ---                                    | 15,569     |
| Other comprehensive loss, net of tax of (\$1,157) | ---          | ---               | (2,149)                                | (2,149)    |
| Cash dividend (\$0.91 per share)                  | ---          | (6,309)           | ---                                    | (6,309)    |
| Balance at December 31, 2010                      | \$ 8,667     | \$ 123,161        | \$ (2,641)                             | \$ 129,187 |
| Net income  | ---          | 17,638            | ---                                    | 17,638     |
| Other comprehensive income, net of tax of \$711   | ---          | ---               | 1,320                                  | 1,320      |
| Cash dividend (\$1.00 per share)                  | ---          | (6,938)           | ---                                    | (6,938)    |
| Exercise of stock options                         | 8            | 84                | ---                                    | 92         |
| Balance at December 31, 2011                      | \$ 8,675     | \$ 133,945        | \$ (1,321)                             | \$ 141,299 |
| Net income  | ---          | 17,747            | ---                                    | 17,747     |
| Other comprehensive loss, net of tax of (\$763)   | ---          | ---               | (1,417)                                | (1,417)    |
| Cash dividend (\$1.10 per share)                  | ---          | (7,639)           | ---                                    | (7,639)    |
| Exercise of stock options                         | 10           | 109               | ---                                    | 119        |
| Balance at December 31, 2012                      | \$ 8,685     | \$ 144,162        | \$ (2,738)                             | \$ 150,109 |

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

## Consolidated Statements of Cash Flows

| \$ in thousands  | Years Ended December 31, |           |           |
|--|--------------------------|-----------|-----------|
|  | 2012                     | 2011      | 2010      |
| <b>Cash Flows from Operating Activities</b>                                      |                          |           |           |
| Net income   | \$ 17,747                | \$ 17,638 | \$ 15,569 |
| Adjustment to reconcile net income to net cash provided by operating activities: |                          |           |           |
| Provision for loan losses  | 3,134                    | 2,949     | 3,409     |
| Deferred income tax expense  | 204                      | 582       | 563       |
| Depreciation of premises and equipment   | 764                      | 799       | 886       |
| Amortization of intangibles  | 1,083                    | 1,083     | 1,083     |
| Amortization of premiums and accretion of discounts, net                         | 224                      | 217       | 300       |
| (Gains) losses on disposal of fixed assets                                       | (3 )                     | 1         | (5 )      |
| (Gains) losses on calls of securities available for sale, net                    | (10 )                    | 26        | (19 )     |
| (Gains) losses on calls of securities held to maturity, net                      | (15 )                    | (37 )     | 33        |
| (Gains) losses and writedowns on other real estate owned                         | (14 )                    | 334       | 63        |
| Originations of mortgage loans held for sale                                     | (22,747 )                | (13,582 ) | (21,929 ) |
| Sales of mortgage loans held for sale  | 22,574                   | 13,419    | 19,595    |
| Net change in:   |                          |           |           |
| Accrued interest receivable  | 57                       | (288 )    | 234       |
| Other assets   | (44 )                    | 501       | (858 )    |
| Accrued interest payable   | (67 )                    | (51 )     | (79 )     |
| Other liabilities  | (175 )                   | (4,135 )  | (280 )    |
| Net cash provided by operating activities  | 22,712                   | 19,456    | 18,565    |
| <b>Cash Flows from Investing Activities</b>                                      |                          |           |           |
| Net change in interest-bearing deposits  | 1,758                    | (28,955 ) | (36,670 ) |
| Proceeds from repayments of mortgage-backed securities                           | 3,160                    | 3,823     | 5,817     |
| Proceeds from calls and maturities of securities available for sale              | 151,051                  | 74,961    | 68,565    |
| Proceeds from calls and maturities of securities held to maturity                | 30,942                   | 22,123    | 39,234    |
| Purchases of securities available for sale                                       | (171,601 )               | (64,567 ) | (93,862 ) |
| Purchases of securities held to maturity   | (47,803 )                | (35,411 ) | (41,297 ) |
| Purchases of loan participations   | 1,988                    | ---       | (55 )     |
| Collections of loan participations   | (2,082 )                 | 934       | 876       |
| Loan originations and principal collections, net                                 | (8,182 )                 | (17,081 ) | 7,820     |
| Purchase of bank-owned life insurance  | ---                      | (1,900 )  | ---       |
| Proceeds from disposal of other real estate owned                                | 1,699                    | 1,391     | 2,393     |
| Recoveries on loans charged off  | 100                      | 84        | 139       |
| Additions to premises and equipment  | (769 )                   | (725 )    | (728 )    |
| Proceeds from sale of premises and equipment                                     | ---                      | 2         | 5         |
| Net cash used in investing activities  | (39,739 )                | (45,321 ) | (47,763 ) |

(continued)





|  |           |           |           |
|--|-----------|-----------|-----------|
| <b>Cash Flows from Financing Activities</b>                |           |           |           |
| Net change in time deposits                                | (33,333 ) | (21,132 ) | (35,109 ) |
| Net change in other deposits                               | 60,766    | 55,882    | 67,580    |
| Cash dividends paid  | (7,639 )  | (6,938 )  | (6,309 )  |
| Stock options exercised                                    | 119       | 92        | ---       |
| Net cash provided by financing activities                  | 19,913    | 27,904    | 26,162    |
| <br>   |           |           |           |
| Net change in cash and due from banks                      | 2,886     | 2,039     | (3,036 )  |
| Cash and due from banks at beginning of year               | 11,897    | 9,858     | 12,894    |
| Cash and due from banks at end of year                     | \$ 14,783 | \$ 11,897 | \$ 9,858  |
| <br>   |           |           |           |
| <b>Supplemental Disclosures of Cash Flow Information</b>   |           |           |           |
| Interest paid on deposits and borrowed funds               | \$ 7,954  | \$ 9,235  | \$ 11,237 |
| Income taxes paid  | 4,930     | 4,779     | 5,478     |
| <br>   |           |           |           |
| <b>Supplemental Disclosures of Noncash Activities</b>      |           |           |           |
| Loans charged against the allowance for loan losses        | \$ 2,953  | \$ 2,628  | \$ 2,810  |
| Loans transferred to other real estate owned               | 1,631     | 1,491     | 2,053     |
| Unrealized gains (losses) on securities available for sale | (922 )    | 4,219     | (2,658 )  |
| Minimum pension liability adjustment                       | (1,258 )  | (2,188 )  | (648 )    |

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

## 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.

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.

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

### Cash and Cash Equivalents

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

### Securities

Certain 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. Trading securities are recorded at fair value with changes in fair value included in earnings. 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. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company follows the accounting guidance related to recognition and presentation of other-than-temporary impairment. The guidance specifies that if (a) an entity does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that the entity will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired, unless there is a credit loss. When criteria (a) and (b) are met, the entity will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the Company does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

### 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 sold with the mortgage servicing rights released by the Company.

### Loans

The Company, through its banking subsidiary, provides mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans, particularly commercial mortgages. 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 Company considers multiple factors when determining whether to discontinue accrual of interest on individual loans. Generally loans are placed in nonaccrual status when collection of interest and/or full principal is considered doubtful. Interest accrual is discontinued at the time a loan is 90 days delinquent unless the credit is well secured and in the process of collection. Loans that are not restructured but that are impaired and have an associated impairment loss are placed on nonaccrual unless the borrower is paying as agreed. Loans that are modified to allow the borrower to discontinue payments of principal or interest for more than 90 days are placed on nonaccrual unless the modification provides reasonable assurance of repayment performance and collateral value supports regular underwriting requirements. If during a reasonable period of nonaccrual the restructured loan demonstrates ability to pay, the loan is returned to accrual status. Loans that finance the sale of OREO property that do not meet down payment thresholds are designated nonaccrual.

All interest accrued but not collected for loans that are placed on nonaccrual or for loans charged off is reversed against interest income. The interest received on nonaccrual 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 current; future payments are reasonably assured; and for loans that financed the sale of OREO property, loan-to-value thresholds are met.

A loan is considered past due when a payment of principal and/or interest is due but not paid. Credit card payments not received within 30 days after the statement date, real estate loan payments not received within the payment cycle; and all other non-real estate secured loans for which payment is not made within 30 days of the payment due date are considered 30 days past due. Management closely monitors past due loans in timeframes of 30-59 days past due, 60-89 days past due and 90 or more days past due.

#### Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable losses inherent in the Company's loan portfolio. A provision for estimated losses is charged to earnings to establish and maintain the allowance for loan losses at a level reflective of the estimated credit risk. When management determines that a loan balance or portion of a loan balance is not collectible, the loss is charged against the allowance. Subsequent recoveries, if any, are credited to the allowance.

Management evaluates the allowance each quarter through a methodology that estimates losses on individual impaired loans and evaluates the effect of numerous factors on the credit risk of groups of homogeneous loans.

Specific allowances are established for individually-evaluated impaired loans based on the excess of the loan balance relative to the fair value of the loan. Impaired loans are designated as such when current information indicates that it is probable that the Company will be unable to collect principal or interest according to the contractual terms of the loan agreement. Loan relationships exceeding \$250,000 in nonaccrual status or that are significantly past due, or for which a credit review identified weaknesses that indicate principal and interest will not be collected according to the loan terms, as well as all loans modified in a troubled debt restructuring, are designated impaired.

Fair value of impaired loans is estimated in one of three ways. These are (1) the estimated fair value (less selling costs) of the underlying collateral, (2) the present value of the loan's expected future cash flows, or (3) the loan's observable market value. The amount of recorded investment (unpaid principal, accrued interest and deferred fees and costs) in an impaired loan that exceeds the fair value is accrued as estimated loss in the allowance. Impaired loans for which collection of interest or principal is in doubt are placed in nonaccrual status.

General allowances are established for collectively-evaluated loans. Collectively-evaluated loans are grouped into classes based on similar characteristics. Factors considered in determining general allowances include net charge-off trends, internal risk ratings, delinquency and nonperforming rates, product mix, underwriting practices, industry trends and economic trends.

The Company's charge-off policy meets or is more stringent than the minimum standards required by regulators. When available information confirms that a specific loan or a portion thereof is uncollectible, the amount is charged off against the allowance for loan losses. Additionally, losses on consumer loans are typically charged off no later than when the loans are 120-180 days past due, and losses on loans secured by residential real estate or by commercial real estate are charged off by the time the loans reach 180 days past due, in compliance with regulatory guidelines. Accordingly, secured loans may be charged down to the estimated value of the collateral, with previously accrued unpaid interest reversed. Subsequent charge-offs may be required as a result of changes in the market value of collateral or other repayment prospects.

#### Troubled Debt Restructurings ("TDRs")

In situations where, for economic or legal reasons related to a borrower's financial condition, management grants a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). These modified terms may include reduction of the interest rate, extension of the maturity date at an interest rate lower than the current market rate for a new loan with similar risk, forgiveness of principal or accrued interest or other actions intended to minimize the economic loss. TDR loans are individually measured for

impairment.

#### Rate Lock Commitments

The Company enters into commitments to originate mortgage loans in which 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.

#### 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 less cost to sell 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 and Goodwill

The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis during the fourth quarter of each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified during the years ended December 31, 2012, 2011 and 2010. Intangible assets include customer deposit intangibles. Such intangible assets are amortized on a straight-line basis over their estimated useful lives, which are generally ten to twelve years.

#### Stock-Based Compensation

The Company's 1999 Stock Option Plan terminated on March 9, 2009. Incentive stock options, all of which are now vested, were granted in the early years of the Plan. The Company recognized the cost of employment services received in exchange for awards of equity instruments based on the fair value of those awards on the date of grant. Compensation cost was recognized over the award's required service period, which was the vesting period.

#### Pension Plan

The Company recognizes the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognizes changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. The benefit obligation is the projected benefit obligation.

#### Income Taxes

Income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest

amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

#### 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 Common Share

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common 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.

The following shows the weighted average number of shares used in computing earnings per common 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.

|   | 2012      | 2011      | 2010      |
|---|-----------|-----------|-----------|
| Average number of common shares outstanding   | 6,942,411 | 6,936,869 | 6,933,474 |
| Effect of dilutive options  | 17,456    | 13,994    | 16,462    |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 6,959,867 | 6,950,863 | 6,949,936 |

The computation of diluted net income per common share excludes shares for stock options that would be anti-dilutive. There were no anti-dilutive shares in 2012. In 2011 and 2010, 5,750 anti-dilutive shares and 7,750 anti-dilutive shares, respectively, were excluded from the computation.

### Advertising

The Company practices the policy of charging advertising costs to expenses as incurred. In 2012, the Company charged \$169 to expenses, and in 2011, \$184 and in 2010, \$163 was expensed.

### 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, the valuation of foreclosed real estate and deferred tax assets, other-than-temporary impairments of securities, the fair value of financial instruments and pension obligations.

Changing economic conditions, adverse economic prospects for borrowers, as 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 April 2011, the FASB issued ASU 2011-03, "Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements." The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.



In May 2011, the FASB issued ASU 2011-04, “Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.” This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, “Comprehensive Income (Topic 220) – Presentation of Comprehensive Income.” The new guidance amends disclosure requirements for the presentation of comprehensive income. The amended guidance eliminates the option to present components of other comprehensive income (“OCI”) as part of the statement of changes in shareholders’ equity. All changes in OCI must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive financial statements. The guidance does not change the items that must be reported in OCI. The Company adopted this guidance effective 2012, and has elected to present two separate but consecutive financial statements.

In September 2011, the FASB issued ASU 2011-08, “Intangible – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment.” The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity’s financial statements for the most recent annual or interim period have not yet been issued. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

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

In July 2012, the FASB issued ASU 2012-02, “Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment.” The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset’s fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company does not expect the adoption of ASU 2012-02 to have a material impact on its consolidated financial statements.

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

In February 2013, the FASB issued ASU 2013-02, “Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.” The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The

Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

Note 2: Restriction on Cash

The Company's subsidiary bank is a member of the Federal Reserve System. In 2011, Federal Reserve policy required members to maintain certain average reserve balances. For the final weekly reporting period in the year ended December 31, 2011, the Bank's daily average required balance was \$350. Federal Reserve policy changed in 2012 and the subsidiary bank was not required to hold an average balance during the final weekly reporting period in the year ended December 31, 2012.

## Note 3: Securities

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

| Available for sale:                       | December 31, 2012 |                              |                               |            |
|---|-------------------|------------------------------|-------------------------------|------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
| U.S. Treasury                             | \$ 2,005          | \$ 68                        | \$ ---                        | \$ 2,073   |
| U.S. Government agencies and corporations | 128,805           | 1,381                        | 622                           | 129,564    |
| States and political subdivisions         | 35,029            | 1,753                        | 3                             | 36,779     |
| Mortgage-backed securities                | 4,202             | 367                          | ---                           | 4,569      |
| Corporate debt securities                 | 14,207            | 368                          | ---                           | 14,575     |
| Federal Home Loan Bank stock – restricted | 1,597             | ---                          | ---                           | 1,597      |
| Federal Reserve Bank stock – restricted   | 92                | ---                          | ---                           | 92         |
| Other securities                          | 2,419             | 9                            | 173                           | 2,255      |
| Total securities available for sale       | \$ 188,356        | \$ 3,946                     | \$ 798                        | \$ 191,504 |

| Available for sale:                       | December 31, 2011 |                              |                               |            |
|---|-------------------|------------------------------|-------------------------------|------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
| U.S. Treasury                             | \$ 2,010          | \$ 140                       | \$ ---                        | \$ 2,150   |
| U.S. Government agencies and corporations | 94,716            | 1,307                        | 20                            | 96,003     |
| States and political subdivisions         | 47,118            | 2,034                        | 30                            | 49,122     |
| Mortgage-backed securities                | 7,156             | 569                          | ---                           | 7,725      |
| Corporate debt securities                 | 15,852            | 322                          | 97                            | 16,077     |
| Federal Home Loan Bank stock – restricted | 1,574             | ---                          | ---                           | 1,574      |
| Federal Reserve Bank stock – restricted   | 92                | ---                          | ---                           | 92         |
| Other securities                          | 2,330             | 7                            | 162                           | 2,175      |
| Total securities available for sale       | \$ 170,848        | \$ 4,379                     | \$ 309                        | \$ 174,918 |

The amortized cost and fair value of single maturity securities available for sale at December 31, 2012, 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, 2012.

|  | December 31, 2012 |            |
|--|-------------------|------------|
|  | Amortized<br>Cost | Fair Value |
| Due in one year or less                | \$ 16,688         | \$ 16,893  |
| Due after one year through five years  | 12,096            | 12,549     |
| Due after five years through ten years | 11,987            | 12,875     |
| Due after ten years                    | 144,165           | 145,931    |
| No maturity                            | 3,420             | 3,256      |
|  | \$ 188,356        | \$ 191,504 |



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

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

| Held to maturity:                         | Amortized<br>Cost | December 31, 2011            |                               | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
|   |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |            |
| U.S. Government agencies and corporations | \$ 22,057         | \$ 562                       | \$ ---                        | \$ 22,619  |
| States and political subdivisions         | 119,381           | 6,775                        | 15                            | 126,141    |
| Mortgage-backed securities                | 902               | 94                           | ---                           | 996        |
| Corporate debt securities                 | 1,655             | 18                           | ---                           | 1,673      |
| Total securities held to maturity         | \$ 143,995        | \$ 7,449                     | \$ 15                         | \$ 151,429 |

The amortized cost and fair value of single maturity securities held to maturity at December 31, 2012, 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, 2012.

|  | December 31, 2012 |               |
|--|-------------------|---------------|
|  | Amortized<br>Cost | Fair<br>Value |
| Due in one year or less                | \$ 3,907          | \$ 3,958      |
| Due after one year through five years  | 8,537             | 8,814         |
| Due after five years through ten years | 13,745            | 15,050        |
| Due after ten years                    | 134,350           | 143,024       |
|  | \$ 160,539        | \$ 170,846    |

Information pertaining to securities with gross unrealized losses at December 31, 2012 and 2011 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|  | December 31, 2012   |                 |                   |                 |
|--|---------------------|-----------------|-------------------|-----------------|
|  | Less Than 12 Months |                 | 12 Months or More |                 |
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 44,351           | \$ 622          | \$ ---            | \$ ---          |
| State and political subdivisions           | 9,358               | 216             | 482               | 3               |
| Other                                      | ---                 | ---             | 133               | 172             |
| Total temporarily impaired securities      | \$ 53,709           | \$ 838          | \$ 615            | \$ 176          |

|  | December 31, 2011   |                 |                   |                 |
|--|---------------------|-----------------|-------------------|-----------------|
|  | Less Than 12 Months |                 | 12 Months or More |                 |
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| U. S. Government agencies and corporations | \$ 6,230            | \$ 20           | \$ ---            | \$ ---          |
| State and political subdivisions           | 3,527               | 19              | 981               | 26              |
| Corporate debt securities                  | 4,916               | 97              | ---               | ---             |
| Other                                      | ---                 | ---             | 142               | 162             |
| Total temporarily impaired securities      | \$ 14,673           | \$ 136          | \$ 1,123          | \$ 188          |

At December 31, 2012, the Company had 59 securities with a fair value of \$54,324 which had total unrealized losses of \$1,014. The Company has made the determination that these securities are temporarily impaired at December 31, 2012 for the following reasons:

**U.S. Government agencies and corporations.** The unrealized losses in this category of investments were caused by interest rate fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and the accounting standard of “more likely than not” has not been met for the Company to be required to sell any of these investments before recovery of its amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired.

**State and political subdivisions.** This category’s unrealized losses are primarily the result of interest rate fluctuations and also a certain few ratings downgrades brought about by the impact of the economic downturn on states and political subdivisions. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and the accounting standard of “more likely than not” has not been met for the Company to be required to sell any of the investments before recovery of its amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired.

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

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

other-than-temporarily impaired.

At December 31, 2011, the Company had 19 securities with a fair value of \$15,796 which were temporarily impaired. The total unrealized loss on these securities, which was attributed to interest rate fluctuations, was \$324. Because the Company had the ability and intent to hold the securities until maturity or until the cost was recovered, the losses associated with the securities were not considered other than temporary at December 31, 2011.

At December 31, 2012 and 2011, securities with a carrying value of \$147,114 and \$147,152, 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 \$129,330, and NBB’s capital stock investment in the FHLB. Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based upon the ultimate recoverability of the cost basis in the FHLB stock.



Note 4: Related Party Transactions

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 \$1,622 at December 31, 2012 and \$3,173 at December 31, 2011. During the year ended December 31, 2012, total principal additions were \$677 and principal payments were \$2,228.

Note 5: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

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

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

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Further, restructured loans are individually evaluated for impairment, with amounts below fair value accrued in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were included in the fair value measurement. TDRs as well as all impaired loans that are determined to be collateral dependent are charged down to fair value. Impairment accounts for TDR's that are not collateral dependent may be accrued in the allowance for loan losses or charged off if deemed appropriate.

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment for application of the allowance for loan losses methodology. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model.

Change in Portfolio Segments and Classes

During the first quarter of 2012, the Company revised its basis for determining segments and classes for the allowance for loan losses. In previous periods, the loan portfolio was segmented primarily by repayment source, whereas beginning with the first quarter of 2012 disaggregation is based primarily upon collateral type for secured loans and borrower type or repayment terms for unsecured loans. This aligns the allowance categories with those used for financial statements and other notes, providing greater uniformity and comparability. Consistent with accounting guidance, prior periods have not been restated and are shown as originally published using the segments and classes in effect for the period. These changes had an insignificant effect on the calculation of the balance in the allowance for loan losses.

The segments and classes used in determining the allowance for loan losses, beginning with 2012 are as follows.

|                                    |                            |
|------------------------------------|----------------------------|
| Real Estate Construction           | Commercial Non Real Estate |
| Construction, residential          | Commercial and Industrial  |
| Construction, other                |                            |
|                                    | Public Sector and IDA      |
| Consumer Real Estate               | Public sector and IDA      |
| Equity lines                       |                            |
| Residential closed-end first liens | Consumer Non Real Estate   |

|  |                      |
|--|----------------------|
| Residential closed-end junior liens    | Credit cards         |
|  | Automobile           |
| Commercial Real Estate                 | Other consumer loans |
| Multifamily real estate                |                      |
| Commercial real estate, owner occupied |                      |
| Commercial real estate, other          |                      |

Prior to the first quarter of 2012, the Company's segments and classes were as follows.

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

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

An analysis of the allowance for loan losses follows:

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2012                     | 2011     | 2010     |
| Balance at beginning of year               | \$ 8,068                 | \$ 7,664 | \$ 6,926 |
| Loans charged off                          | (2,953 )                 | (2,628 ) | (2,810 ) |
| Recoveries of loans previously charged off | 100                      | 83       | 139      |
| Provision for loan losses                  | 3,134                    | 2,949    | 3,409    |
| Balance at end of year                     | \$ 8,349                 | \$ 8,068 | \$ 7,664 |

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

| Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2012 |                                |                            |                              |                                  |                             |                                |             |          |
|---|--------------------------------|----------------------------|------------------------------|----------------------------------|-----------------------------|--------------------------------|-------------|----------|
|   | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and IDA | Consumer<br>Non Real<br>Estate | Unallocated | Total    |
| Balance,<br>December<br>31, 2011  | \$ 1,079                       | \$ 1,245                   | \$ 3,515                     | \$ 1,473                         | \$ 232                      | \$ 403                         | \$ 121      | \$ 8,068 |
| Charge-offs   | (640)                          | (370)                      | (1,589)                      | (109)                            | ---                         | (245)                          | ---         | (2,953)  |
| Recoveries  | 13                             | 8                          | ---                          | 2                                | ---                         | 77                             | ---         | 100      |
|   | 723                            | 1,380                      | 1,389                        | (410)                            | (90)                        | 182                            | (40)        | 3,134    |

Provision  
for loan  
losses

Balance,  
December

|         |          |          |          |        |        |        |       |          |
|---------|----------|----------|----------|--------|--------|--------|-------|----------|
| 31,2012 | \$ 1,175 | \$ 2,263 | \$ 3,315 | \$ 956 | \$ 142 | \$ 417 | \$ 81 | \$ 8,349 |
|---------|----------|----------|----------|--------|--------|--------|-------|----------|

Activity in the Allowance for Loan Losses by Segment for the year ended  
December 31, 2011(1)

|                                  | Consumer<br>Real<br>Estate | Consumer<br>Non-Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>&<br>Industrial | Construction,<br>Development<br>& Other<br>Land | Unallocated | Total    |
|----------------------------------|----------------------------|--------------------------------|------------------------------|-------------------------------|---|-------------|----------|
| Balance,<br>December 31,<br>2010 | \$ 1,059                   | \$ 586                         | \$ 4,033                     | \$ 1,108                      | \$ 749  | \$ 129      | \$ 7,664 |
| Charge-offs                      | (461 )                     | (266 )                         | (457 )                       | (655 )                        | (789 )  | ---         | (2,628 ) |
| Recoveries                       | 14                         | 68                             | ---                          | 1                             | ---   | ---         | 83       |
| Provision for<br>loan losses     | 440                        | 13                             | 935                          | 581                           | 988   | (8 )        | 2,949    |
| Balance,<br>December 31,<br>2011 | \$ 1,052                   | \$ 401                         | \$ 4,511                     | \$ 1,035                      | \$ 948  | \$ 121      | \$ 8,068 |

(1) Segments reported for December 31, 2011 and December 31, 2010 are presented using the segmentation method in effect for 2011 and 2010. The Company began reporting under revised segments beginning 2012.

Activity in the Allowance for Loan Losses by Segment for the year ended  
December 31, 2010(1)

|                                  | Consumer<br>Real<br>Estate | Consumer<br>Non-Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>&<br>Industrial | Construction,<br>Development<br>& Land | Unallocated | Total    |
|----------------------------------|----------------------------|--------------------------------|------------------------------|-------------------------------|--|-------------|----------|
| Balance,<br>December 31,<br>2009 | \$ 249                     | \$ 1,049                       | \$ 4,321                     | \$ 459                        | \$ 562                                 | \$ 286      | \$ 6,926 |
| Charge-offs                      | (89 )                      | (358 )                         | (1,021 )                     | (927 )                        | (415 )                                 | ---         | (2,810 ) |
| Recoveries                       | 10                         | 67                             | 61                           | 1                             | ---                                    | ---         | 139      |
| Provision for<br>loan losses     | 889                        | (172 )                         | 672                          | 1,575                         | 602                                    | (157 )      | 3,409    |
| Balance,<br>December 31,<br>2010 | \$ 1,059                   | \$ 586                         | \$ 4,033                     | \$ 1,108                      | \$ 749                                 | \$ 129      | \$ 7,664 |

Allowance for Loan Losses  
by Segment and Evaluation Method as of  
December 31, 2012

|   | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real<br>Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and IDA | Consumer<br>Non Real<br>Estate | Unallocated | Total  |
|---|--------------------------------|----------------------------|------------------------------|----------------------------------|-----------------------------|--------------------------------|-------------|--------|
| Individually<br>evaluated for<br>impairment | \$ ---                         | \$ 43                      | \$ ---                       | \$ 226                           | \$ ---                      | \$ ---                         | \$ ---      | \$ 269 |
| Collectively<br>evaluated for<br>impairment | 1,175                          | 2,220                      | 3,315                        | 730                              | 142                         | 417                            | 81          | 8,080  |

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|       |          |          |          |        |        |        |       |          |
|-------|----------|----------|----------|--------|--------|--------|-------|----------|
| Total | \$ 1,175 | \$ 2,263 | \$ 3,315 | \$ 956 | \$ 142 | \$ 417 | \$ 81 | \$ 8,349 |
|-------|----------|----------|----------|--------|--------|--------|-------|----------|

Loans  
by Segment and Evaluation Method as of  
December 31, 2012

|   | Real<br>Estate<br>Construction | Consumer<br>Real<br>Estate | Commercial<br>Real Estate | Commercial<br>Non Real<br>Estate | Public<br>Sector<br>and IDA | Consumer<br>Non Real<br>Estate | Unallocated | Total     |
|---|--------------------------------|----------------------------|---------------------------|----------------------------------|-----------------------------|--------------------------------|-------------|-----------|
| Individually<br>evaluated for<br>impairment | \$3,623                        | \$864                      | \$ 6,048                  | \$ 518                           | \$---                       | \$---                          | \$ ---      | \$11,053  |
| Collectively<br>evaluated for<br>impairment | 46,690                         | 142,398                    | 298,260                   | 36,831                           | 26,169                      | 31,714                         | ---         | 582,062   |
| Total                                       | \$50,313                       | \$143,262                  | \$ 304,308                | \$ 37,349                        | \$26,169                    | \$31,714                       | \$ ---      | \$593,115 |

Allowance for Loan Losses  
by Segment and Evaluation Method as of  
December 31, 2011(1)

|  | Consumer<br>Real Estate | Consumer<br>Non-Real<br>Estate | Commercial<br>Real Estate | Commercial<br>&<br>Industrial | Construction,<br>Development<br>& Other<br>Land | Unallocated   | Total           |
|--|-------------------------|--------------------------------|---------------------------|-------------------------------|---|---------------|-----------------|
| Individually evaluated<br>for impairment | \$ ---                  | \$ ---                         | \$ 1,014                  | \$ 62                         | \$ 47   | \$ ---        | \$ 1,123        |
| Collectively evaluated<br>for impairment | 1,052                   | 401                            | 3,497                     | 973                           | 901   | 121           | 6,945           |
| <b>Total</b>                             | <b>\$ 1,052</b>         | <b>\$ 401</b>                  | <b>\$ 4,511</b>           | <b>\$ 1,035</b>               | <b>\$ 948</b>                                   | <b>\$ 121</b> | <b>\$ 8,068</b> |

(1) Segments reported for December 31, 2011 and December 31, 2010 are presented using the segmentation method in effect for 2011 and 2010. The Company began reporting under revised segments beginning 2012.

Loans  
by Segment and Evaluation Method as of  
December 31, 2011(1)

|  | Consumer<br>Real Estate | Consumer<br>Non-Real<br>Estate | Commercial<br>Real Estate | Commercial<br>&<br>Industrial | Construction,<br>Development<br>& Other<br>Land | Unallocated   | Total             |
|--|-------------------------|--------------------------------|---------------------------|-------------------------------|---|---------------|-------------------|
| Individually evaluated<br>for impairment | \$ 238                  | \$ ---                         | \$ 9,067                  | \$ 139                        | \$ 3,152  | \$ ---        | \$ 12,596         |
| Collectively evaluated<br>for impairment | 109,843                 | 29,707                         | 357,507                   | 37,584                        | 41,233  | ---           | 575,874           |
| <b>Total</b>                             | <b>\$ 110,081</b>       | <b>\$ 29,707</b>               | <b>\$ 366,574</b>         | <b>\$ 37,723</b>              | <b>\$ 44,385</b>                                | <b>\$ ---</b> | <b>\$ 588,470</b> |

(1) Segments reported for December 31, 2011 and December 31, 2010 are presented using the segmentation method in effect for 2011 and 2010. The Company began reporting under revised segments beginning 2012.

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

|   | 2012  | December 31,<br>2011 | 2010  |
|---|-------|----------------------|-------|
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees | 1.41% | 1.37%                | 1.33% |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees                     | 0.49% | 0.43%                | 0.46% |

A summary of nonperforming assets follows:

|                                  | 2012     | December 31,<br>2011 | 2010     |
|----------------------------------|----------|----------------------|----------|
| Nonperforming assets:            |          |                      |          |
| Nonaccrual loans                 | \$ 3,466 | \$ 1,398             | \$ 1,938 |
| Restructured loans in nonaccrual | 2,151    | 3,806                | 6,133    |

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|  |          |   |          |   |          |
|--|----------|---|----------|---|----------|
| Total nonperforming loans  | 5,617    |   | 5,204    |   | 8,071    |
| Other real estate owned, net   | 1,435    |   | 1,489    |   | 1,723    |
| Total nonperforming assets   | \$ 7,052 |   | \$ 6,693 |   | \$ 9,794 |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned | 1.19     | % | 1.13     | % | 1.69     |
| Ratio of allowance for loan losses to nonperforming loans(1)   | 148.64   | % | 155.03   | % | 94.96    |

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



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

|   | 2012 |        | December 31,<br>2011 |          | 2010 |          |
|---|------|--------|----------------------|----------|------|----------|
| Loans past due 90 days or more and still accruing   | \$   | 170    | \$                   | 481      | \$   | 1,336    |
| Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees |      | 0.03 % |                      | 0.08 %   |      | 0.23 %   |
| Accruing restructured loans   | \$   | 2,005  | \$                   | 3,756    | \$   | 350      |
| Impaired loans:   |      |        |                      |          |      |          |
| Impaired loans with no valuation allowance  | \$   | 10,422 | \$                   | 5,505    | \$   | 1,115    |
| Impaired loans with a valuation allowance   |      | 631    |                      | 7,091    |      | 7,676    |
| Total impaired loans  |      | 11,053 |                      | 12,596   |      | 8,791    |
| Valuation allowance   |      | (269 ) |                      | (1,123 ) |      | (1,200 ) |
| Impaired loans, net of allowance  | \$   | 10,784 | \$                   | 11,473   | \$   | 7,591    |
| Average recorded investment in impaired loans(1)  | \$   | 13,520 | \$                   | 8,734    | \$   | 7,526    |
| Income recognized on impaired loans, after designation as impaired  | \$   | 9      | \$                   | 141      | \$   | 17       |
| Amount of income recognized on a cash basis   | \$   | ---    | \$                   | ---      | \$   | ---      |

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

No interest income was recognized on nonaccrual loans for the years ended December 31, 2012, 2011 or 2010. Nonaccrual loans that meet the Company's balance thresholds are designated as impaired.

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

|  | Impaired Loans as of December 31, 2012 |                                  |   |  |                   |
|--|--|----------------------------------|---|--|-------------------|
|  | Principal Balance                      | (A) Total Recorded Investment(1) | Recorded Investment(1) in (A) for Which There is No Related Allowance | Recorded Investment(1) in (A) for Which There is a Related Allowance | Related Allowance |
| <b>Real Estate Construction</b>        |  |                                  |   |  |                   |
| Construction, residential              | \$ 123                                 | \$ 118                           | \$ 118  | \$ ---   | \$ ---            |
| Construction, other                    | 3,500                                  | 3,481                            | 3,481   | ---  | ---               |
| <b>Consumer Real Estate</b>            |  |                                  |   |  |                   |
| Equity lines                           | ---                                    | ---                              | ---   | ---  | ---               |
| Residential closed-end first liens     | 783                                    | 785                              | 634   | 151  | 43                |
| Residential closed-end junior liens    | 81                                     | 81                               | 81  | ---  | ---               |
| <b>Commercial Real Estate</b>          |  |                                  |   |  |                   |
| Multifamily real estate                | 1,752                                  | 1,760                            | 1,760   | ---  | ---               |
| Commercial real estate, owner occupied | 4,296                                  | 4,293                            | 4,293   | ---  | ---               |
| Commercial real estate, other          | ---                                    | ---                              | ---   | ---  | ---               |
| <b>Commercial Non Real Estate</b>      |  |                                  |   |  |                   |
| Commercial and Industrial              | 518                                    | 519                              | 40  | 479  | 226               |
| <b>Public Sector and IDA</b>           |  |                                  |   |  |                   |
| Public sector and IDA                  | ---                                    | ---                              | ---   | ---  | ---               |
| <b>Consumer Non Real Estate</b>        |  |                                  |   |  |                   |
| Credit cards                           | ---                                    | ---                              | ---   | ---  | ---               |
| Automobile                             | ---                                    | ---                              | ---   | ---  | ---               |
| Other consumer loans                   | ---                                    | ---                              | ---   | ---  | ---               |
| <b>Total</b>                           | <b>\$ 11,053</b>                       | <b>\$ 11,037</b>                 | <b>\$ 10,407</b>  | <b>\$ 630</b>  | <b>\$ 269</b>     |

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



|  | Impaired Loans as of December 31, 2011(3) |                                  |   |  |                   |
|--|---|----------------------------------|---|--|-------------------|
|  | Principal Balance                         | (A) Total Recorded Investment(1) | Recorded Investment(1) in (A) for Which There is No Related Allowance | Recorded Investment(1) in (A) for Which There is a Related Allowance | Related Allowance |
| <b>Consumer Real Estate(2)</b>               |   |                                  |   |  |                   |
| Closed-end Consumer Real Estate              | \$ 237                                    | \$ 237                           | \$ 237  | \$ ---   | \$ ---            |
| <b>Commercial Real Estate(2)</b>             |   |                                  |   |  |                   |
| College housing                              | 366                                       | 366                              | 366   | ---  | ---               |
| Office and Retail                            | 3,500                                     | 3,500                            | ---   | 3,500  | 57                |
| Hotel  | 3,319                                     | 3,320                            | 2,794   | 526  | 16                |
| Medical Professionals                        | 66  | 67                               | ---   | 67   | 66                |
| General contractors                          | 703                                       | 703                              | 176   | 527  | 402               |
| Other commercial real estate                 | 1,113                                     | 1,112                            | 425   | 687  | 474               |
| <b>Commercial and Industrial(2)</b>          |   |                                  |   |  |                   |
| Commercial and Industrial                    | 139                                       | 139                              | ---   | 139  | 62                |
| <b>Construction, Development and Land(2)</b> |   |                                  |   |  |                   |
| Residential                                  | 2,901                                     | 2,912                            | 1,256   | 1,656  | 46                |
| Commercial                                   | 252                                       | 252                              | 252   | ---  | ---               |
| <b>Total</b>                                 | <b>\$ 12,596</b>                          | <b>\$ 12,608</b>                 | <b>\$ 5,506</b>   | <b>\$ 7,102</b>  | <b>\$ 1,123</b>   |

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

(2) Only classes with impaired loans are shown.

(3) Segments and classes at December 31, 2011 are reported using the segmentation method in effect for 2011. The Company began reporting under revised segments beginning in 2012.

|                                       | Impaired Loans as of December 31, 2010(3) |   |   |  |                      |
|---------------------------------------|---|---|---|--|----------------------|
|                                       | Principal<br>Balance                      | (A)<br>Total<br>Recorded<br>Investment(1) | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is No<br>Related<br>Allowance | Recorded<br>Investment(1)<br>in (A) for<br>Which<br>There is a<br>Related<br>Allowance | Related<br>Allowance |
| Consumer Real Estate(2)               |   |   |   |  |                      |
| Closed-end Consumer Real Estate       | \$ 505                                    | \$ 505                                    | \$ ---  | \$ 505   | \$ 26                |
| Commercial Real Estate(2)             |   |   |   |  |                      |
| Hotel                                 | 3,509                                     | 3,509                                     | 287   | 3,222  | 267                  |
| Convenience stores                    | 577                                       | 592                                       | 592   | ---  | ---                  |
| Other commercial real estate          | 1,065                                     | 1,066                                     | ---   | 1,066  | 299                  |
| Commercial and Industrial(2)          |   |   |   |  |                      |
| Commercial and Industrial             | 698                                       | 698                                       | ---   | 698  | 508                  |
| Construction, Development and Land(2) |   |   |   |  |                      |
| Residential                           | 2,185                                     | 2,185                                     | ---   | 2,185  | 100                  |
| Commercial                            | 252                                       | 253                                       | 253   | ---  | ---                  |
| Total                                 | \$ 8,791                                  | \$ 8,808                                  | \$ 1,132  | \$ 7,676   | \$ 1,200             |

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

(2) Only classes with impaired loans are shown.

(3) Segments reported for December 31, 2011 and December 31, 2010 are presented using the segmentation method in effect for 2011 and 2010. The Company began reporting under revised segments beginning 2012.

Average Investment and Interest  
Income for Impaired Loans  
For the Year Ended  
December 31, 2012

Average  
Recorded  
Investment(1)                      Interest  
Income  
Recognized

|  |           |        |
|--|-----------|--------|
| Real Estate Construction               |           |        |
| Construction, residential              | \$ 1,171  | \$ --- |
| Construction, other                    | 4,282     | 1      |
| Commercial Real Estate                 |           |        |
| Equity lines                           | 101       | ---    |
| Residential closed-end first liens     | 873       | 2      |
| Residential closed-end junior liens    | 234       | ---    |
| Commercial Real Estate                 |           |        |
| Multifamily real estate                | 1,456     | 5      |
| Commercial real estate, owner occupied | 4,804     | 1      |
| Commercial real estate, other          | ---       | ---    |
| Commercial Non Real Estate             |           |        |
| Commercial and Industrial              | 570       | ---    |
| Public Sector and IDA                  |           |        |
| Public sector and IDA                  | ---       | ---    |
| Consumer Non Real Estate               |           |        |
| Credit cards                           | ---       | ---    |
| Automobile                             | 4         | ---    |
| Other consumer                         | 25        | ---    |
| Total                                  | \$ 13,520 | \$ 9   |

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

|                                       | Average Investment and Interest Income for Impaired Loans |                                  |  |                                  |
|---------------------------------------|---|----------------------------------|--|----------------------------------|
|                                       | For the Year Ended<br>December 31, 2011(3)                |                                  | For the Year Ended<br>December 31, 2010(3) |                                  |
|                                       | Average<br>Recorded<br>Investment(1)                      | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment(1)       | Interest<br>Income<br>Recognized |
| Consumer Real Estate(2)               |   |                                  |  |                                  |
| Closed-end Consumer Real Estate       | \$ 450  | \$ 3                             | \$ 337                                     | \$ ---                           |
| Commercial Real Estate(2)             |   |                                  |  |                                  |
| College Housing                       | 281   | 7                                | ---  | ---                              |
| Office and Retail                     | 292   | ---                              | 253  | ---                              |
| Hotels                                | 3,445   | 41                               | 2,767                                      | ---                              |
| Medical Professionals                 | 67  | 5                                | ---  | ---                              |
| Convenience Stores                    | ---   | ---                              | 49   | 15                               |
| General Contractors                   | 112   | 4                                | ---  | ---                              |
| Other Commercial Real Estate          | 1,139   | 24                               | 337  | 1                                |
| Commercial & Industrial(2)            |   |                                  |  |                                  |
| Commercial & Industrial               | 553   | ---                              | 1,183                                      | ---                              |
| Construction, Development and Land(2) |   |                                  |  |                                  |
| Residential                           | 2,143   | 49                               | 2,579                                      | ---                              |
| Commercial                            | 252   | 8                                | 21   | 1                                |
| Total                                 | \$ 8,734  | \$ 141                           | \$ 7,526                                   | \$ 17                            |

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

(2) Only classes with impaired loans are shown.

(3) Segments reported for December 31, 2011 and December 31, 2010 are presented using the segmentation method in effect for 2011 and 2010. The Company began reporting under revised segments beginning 2012.

An analysis of past due and nonaccrual loans follows:

December 31, 2012

|  | 30 – 89 Days<br>Past Due | 90 or More<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due and Still<br>Accruing | Nonaccruals<br>(Including<br>Impaired<br>Nonaccruals) |
|--|--------------------------|--------------------------------|--|---|
| <b>Real Estate Construction</b>        |                          |                                |  |   |
| Construction, residential              | \$ ---                   | \$ 123                         | \$ ---   | \$ 123  |
| Construction, other                    | 31                       | 89                             | ---  | 89  |
| <b>Consumer Real Estate</b>            |                          |                                |  |   |
| Equity lines                           | 22                       | 30                             | 30   | 98  |
| Residential closed-end first liens     | 1,507                    | 605                            | 126  | 801   |
| Residential closed-end junior liens    | 121                      | 39                             | ---  | 120   |
| <b>Commercial Real Estate</b>          |                          |                                |  |   |
| Multifamily real estate                | 4,202                    | 261                            | ---  | 1,093   |
| Commercial real estate, owner occupied | 1,113                    | ---                            | ---  | 2,785   |
| Commercial real estate, other          | 40                       | 2,089                          | ---  | ---   |
| <b>Commercial Non Real Estate</b>      |                          |                                |  |   |
| Commercial and Industrial              | 347                      | 505                            | ---  | 505   |
| <b>Public Sector and IDA</b>           |                          |                                |  |   |
| Public sector and IDA                  | ---                      | ---                            | ---  | ---   |
| <b>Consumer Non Real Estate</b>        |                          |                                |  |   |
| Credit cards                           | 20                       | 4                              | 4  | ---   |
| Automobile                             | 142                      | 10                             | 10   | 3   |
| Other consumer loans                   | 132                      | ---                            | ---  | ---   |
| <b>Total</b>                           | <b>\$ 7,677</b>          | <b>\$ 3,755</b>                | <b>\$ 170</b>  | <b>\$ 5,617</b>                                       |



December 31, 2011(1)

|   | 30 – 89 Days Past Due | 90 or More Days Past Due | 90 Days Past Due and Still Accruing | Nonaccruals (Including Impaired Nonaccruals) |
|---|-----------------------|--------------------------|-------------------------------------|--|
| <b>Consumer Real Estate</b>               |                       |                          |                                     |  |
| Equity Lines                              | \$ ---                | \$ ---                   | \$ ---                              | \$ ---                                       |
| Closed-ended Consumer Real Estate         | 1,735                 | 658                      | 346                                 | 313  |
| Consumer Construction                     | ---                   | ---                      | ---                                 | ---  |
| <b>Consumer Non-Real Estate</b>           |                       |                          |                                     |  |
| Credit Cards                              | 26                    | 8                        | 8                                   | ---  |
| Consumer General                          | 270                   | 38                       | 38                                  | ---  |
| Consumer Overdraft                        | ---                   | ---                      | ---                                 | ---  |
| <b>Commercial Real Estate</b>             |                       |                          |                                     |  |
| College Housing                           | 452                   | 250                      | ---                                 | 250  |
| Office/Retail                             | ---                   | ---                      | ---                                 | ---  |
| Nursing Homes                             | ---                   | ---                      | ---                                 | ---  |
| Hotels                                    | 616                   | 526                      | ---                                 | 1,397  |
| Municipalities                            | ---                   | ---                      | ---                                 | ---  |
| Medical Professionals                     | ---                   | ---                      | ---                                 | ---  |
| Religious Organizations                   | ---                   | ---                      | ---                                 | ---  |
| Convenience Stores                        | ---                   | ---                      | ---                                 | ---  |
| Entertainment and Sports                  | ---                   | ---                      | ---                                 | ---  |
| Nonprofits                                | ---                   | ---                      | ---                                 | ---  |
| Restaurants                               | ---                   | ---                      | ---                                 | ---  |
| General Contractors                       | 103                   | ---                      | ---                                 | 703  |
| Other Commercial Real Estate              | 815                   | 488                      | 63                                  | 1,112  |
| <b>Commercial and Industrial</b>          |                       |                          |                                     |  |
| Commercial and Industrial                 | 31                    | 26                       | 26                                  | 139  |
| <b>Construction, Development and Land</b> |                       |                          |                                     |  |
| Residential                               | ---                   | 1,290                    | ---                                 | 1,290  |
| Commercial                                | 252                   | ---                      | ---                                 | ---  |
| <b>Total</b>                              | <b>\$ 4,300</b>       | <b>\$ 3,284</b>          | <b>\$ 481</b>                       | <b>\$ 5,204</b>                              |

(1) Segments and classes at December 31, 2011 are reported using the segmentation method in effect for 2011. The Company began reporting under revised segments beginning in 2012.

The estimate of credit risk for non-impaired loans is obtained by applying allocations for internal and external factors. The allocations are increased for loans that exhibit greater credit quality risk. Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do not indicate heightened risk are graded as "pass." Loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than 75 days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans with frequent or persistent delinquency exceeding 75 days or that have a higher

level of weakness in the borrower's financial condition are graded "classified." Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by 50% and by 100% for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of December 31, 2012, 2011 and 2010.

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

December 31, 2012

|                                       | Pass       | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|---------------------------------------|------------|--------------------|---------------------------------------|
| <b>Real Estate Construction</b>       |            |                    |                                       |
| Construction, 1-4 family residential  | \$ 14,344  | \$ 158             | \$ ---                                |
| Construction, other                   | 29,011     | 3,020              | 120                                   |
| <b>Consumer Real Estate</b>           |            |                    |                                       |
| Equity lines                          | 17,742     | 100                | 182                                   |
| Closed-end first liens                | 113,893    | 652                | 2,413                                 |
| Closed-end junior liens               | 6,713      | 119                | 138                                   |
| <b>Commercial Real Estate</b>         |            |                    |                                       |
| Multifamily residential real estate   | 36,432     | 3,520              | 324                                   |
| Commercial real estate owner-occupied | 160,188    | 1,004              | 1,079                                 |
| Commercial real estate other          | 92,628     | 3,112              | ---                                   |
| <b>Commercial Non Real Estate</b>     |            |                    |                                       |
| Commercial and Industrial             | 36,374     | 152                | 318                                   |
| <b>Public Sector and IDA</b>          |            |                    |                                       |
| States and political subdivisions     | 26,170     | ---                | ---                                   |
| <b>Consumer Non Real Estate</b>       |            |                    |                                       |
| Credit cards                          | 6,690      | ---                | ---                                   |
| Automobile                            | 12,391     | 101                | 56                                    |
| Other consumer                        | 11,815     | 45                 | 105                                   |
| Total                                 | \$ 564,391 | \$ 11,983          | \$ 4,735                              |

December 31, 2011(1)

|   | Pass              | Special<br>Mention | Classified<br>(Excluding<br>Impaired) |
|---|-------------------|--------------------|---------------------------------------|
| <b>Consumer Real Estate</b>               |                   |                    |                                       |
| Equity Lines                              | \$ 17,971         | \$ ---             | \$ 14                                 |
| Closed-ended Consumer Real Estate         | 87,882            | 595                | 1,332                                 |
| Consumer Construction                     | 2,050             | ---                | ---                                   |
| <b>Consumer Non-Real Estate</b>           |                   |                    |                                       |
| Credit Cards                              | 6,594             | ---                | 1                                     |
| Consumer General                          | 22,679            | 42                 | 105                                   |
| Consumer Overdraft                        | 285               | ---                | 1                                     |
| <b>Commercial Real Estate</b>             |                   |                    |                                       |
| College Housing                           | 88,157            | 452                | 215                                   |
| Office/Retail                             | 73,106            | 420                | 267                                   |
| Nursing Homes                             | 16,173            | ---                | ---                                   |
| Hotel                                     | 24,498            | ---                | 616                                   |
| Municipalities                            | 19,230            | ---                | ---                                   |
| Medical Professionals                     | 18,577            | ---                | ---                                   |
| Religious Organizations                   | 15,852            | ---                | ---                                   |
| Convenience Stores                        | 10,519            | ---                | ---                                   |
| Entertainment and Sports                  | 7,346             | ---                | ---                                   |
| Nonprofit                                 | 3,265             | 3,170              | ---                                   |
| Restaurants                               | 6,138             | ---                | 387                                   |
| General Contractors                       | 4,550             | 109                | 247                                   |
| Other Commercial Real Estate              | 63,422            | ---                | 790                                   |
| <b>Commercial and Industrial</b>          |                   |                    |                                       |
| Commercial and Industrial                 | 37,252            | 196                | 137                                   |
| <b>Construction, Development and Land</b> |                   |                    |                                       |
| Residential                               | 15,732            | ---                | ---                                   |
| Commercial                                | 22,409            | 2,961              | 130                                   |
| <b>Total</b>                              | <b>\$ 563,687</b> | <b>\$ 7,945</b>    | <b>\$ 4,242</b>                       |

(1) Segments and classes at December 31, 2011 are reported using the segmentation method in effect for 2011. The Company began reporting under revised segments beginning in 2012.

#### Sales, Purchases and Reclassification of Loans

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



### Troubled Debt Restructurings

From time to time the Company modifies loans in troubled debt restructurings (“TDRs”). The following tables present restructurings by class that occurred during the years ended December 31, 2012 and 2011.

Note: only classes with restructured loans are presented.

|                                       | Restructurings that occurred during the year ended |                  |                   |               |
|---------------------------------------|--|------------------|-------------------|---------------|
|                                       | December 31, 2012                                  |                  |                   |               |
|                                       | Number of  | Pre-Modification | Post-Modification | Impairment    |
|                                       | Contracts  | Outstanding      | Outstanding       | Accrued as    |
|                                       |  | Recorded         | Recorded          | of            |
|                                       |  | Investment       | Investment(1)     | 12/31/2012    |
| <b>Consumer Real Estate</b>           |  |                  |                   |               |
| Closed-end first liens                | 5  | \$ 389           | \$ 348            | \$ 43         |
| Closed-end junior liens               | 1  | 147              | 93                | ---           |
| <b>Commercial Real Estate</b>         |  |                  |                   |               |
| Commercial real estate owner-occupied | 3  | 890              | 895               | ---           |
| <b>Commercial Non Real Estate</b>     |  |                  |                   |               |
| Commercial and Industrial             | 1  | 400              | 400               | 167           |
| <b>Total</b>                          | <b>10</b>  | <b>\$ 1,826</b>  | <b>\$ 1,736</b>   | <b>\$ 210</b> |

(1) Post-modification outstanding recorded investment considers amounts immediately following the modification. Amounts do not reflect balances at the end of the period.

|   | Restructurings that occurred during the year ended |                  |                   |               |
|---|--|------------------|-------------------|---------------|
|   | December 31, 2011(2)                               |                  |                   |               |
|   | Number of  | Pre-Modification | Post-Modification | Impairment    |
|   | Contracts  | Outstanding      | Outstanding       | Accrued as    |
|   |  | Recorded         | Recorded          | of            |
|   |  | Investment       | Investment(1)     | 12/31/2011    |
| <b>Consumer Real Estate</b>               |  |                  |                   |               |
| Closed-end Consumer Real Estate           | 2  | \$ 290           | \$ 92             | \$ ---        |
| <b>Commercial Real Estate</b>             |  |                  |                   |               |
| College housing                           | 2  | 419              | 332               | ---           |
| Medical professionals                     | 3  | 79               | 79                | 66            |
| General contractors                       | 2  | 128              | 128               | 128           |
| Other commercial real estate              | 3  | 680              | 726               | 474           |
| <b>Commercial and Industrial</b>          |  |                  |                   |               |
|   | 1  | 50               | 50                | 50            |
| <b>Construction, Development and Land</b> |  |                  |                   |               |
| Residential                               | 3  | 2,474            | 1,645             | 47            |
| <b>Total</b>                              | <b>16</b>  | <b>\$ 4,120</b>  | <b>\$ 3,052</b>   | <b>\$ 765</b> |

- (1) Post-modification outstanding recorded investment considers amounts immediately following the modification. Amounts do not reflect balances at the end of the period.
- (2) Segments and classes at December 31, 2011 are reported using the segmentation method in effect for 2011. The Company began reporting under revised segments beginning in 2012.

Loans restructured in 2012 received modifications that included partial charge-offs of \$109 for two consumer real estate loans; providing payment relief primarily by extending maturity dates or changing amortization structures without reducing interest rates or amounts owed; and adding a co-borrower to one consumer real estate loan. Of the loans that were restructured in 2011, five received partial charge-offs totaling \$1,143. One construction loan accounted for \$789 of the amount. Partial charge-offs are included in the loss ratios applied in the determination of the allowance for collectively-evaluated loans.

Restructured loans are designated impaired and measured for impairment. The impairment measurement for restructured loans that occurred in 2012 resulted in an accrual to the allowance for loan losses of \$210 at December 31, 2012. Restructurings in 2011 resulted in an accrual to the allowance for loan losses of \$765 at December 31, 2011.

The following tables present restructured loans that were modified during 2012 and 2011 and that subsequently experienced payment default. The company defines default as one or more payments that occur more than 90 days past the due date.

|                                       | Restructurings that defaulted during the year ended<br>December 31, 2012 that were modified within 12<br>months prior to default |                        |                       |
|---------------------------------------|--|------------------------|-----------------------|
|                                       | Number of<br>Contracts   | Recorded<br>Investment | Impairment<br>Accrued |
| Consumer Real Estate                  |  |                        |                       |
| Closed-end first liens                | 1  | 96                     | ---                   |
| Closed-end junior liens               | 1  | 81                     | ---                   |
| Commercial Real Estate                |  |                        |                       |
| Commercial real estate owner occupied | 2  | 861                    | ---                   |
| Commercial Non Real Estate            |  |                        |                       |
| Commercial and industrial             | 1  | 388                    | 167                   |
| Total                                 | 5  | \$ 1,426               | \$ 167                |

|                                    | Restructurings that defaulted during the year ended<br>December 31, 2011(1) that were modified within 12<br>months prior to default |                        |                       |
|------------------------------------|---|------------------------|-----------------------|
|                                    | Number of<br>Contracts  | Recorded<br>Investment | Impairment<br>Accrued |
| Consumer Real Estate               |   |                        |                       |
| Closed-end Consumer Real Estate    | 2   | \$ 92                  | \$ ---                |
| Commercial Real Estate             |   |                        |                       |
| College housing                    | 1   | 250                    | ---                   |
| General contractors                | 2   | 128                    | 128                   |
| Other commercial real estate       | 3   | 687                    | 474                   |
| Commercial and Industrial          |   |                        |                       |
|                                    | 1   | 50                     | 50                    |
| Construction, Development and Land |   |                        |                       |
| Residential                        | 3   | 1,645                  | 46                    |
| Total                              | 12  | \$ 2,852               | \$ 698                |



- (1) Segments and classes at December 31, 2011 are reported using the segmentation method in effect for 2011. The Company began reporting under revised segments beginning in 2012.

Most of the restructured loans that experienced a payment default are secured by real estate, for which the impairment measurement is based upon the fair value of the underlying collateral. The amount of the loan balance that exceeds the collateral value is accrued in the allowance for loan losses. One loan reported in 2011 is unsecured and is fully accrued in the allowance for loan losses at December 31, 2011. Because fair value measurements are based upon fair value of collateral, the payment default did not significantly impact the measurement of impairment. Restructured loans that become more than 90 days past due are designated nonaccrual. Nonaccrual levels are factored into allowance methodology for collectively-evaluated loans.

#### Note 6: Premises and Equipment

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

|                             | December 31, |           |
|-----------------------------|--------------|-----------|
|                             | 2012         | 2011      |
| Premises                    | \$ 14,320    | \$ 14,172 |
| Furniture and equipment     | 10,424       | 9,804     |
| Premises and equipment      | \$ 24,744    | \$ 23,976 |
| Accumulated depreciation    | (14,343 )    | (13,583 ) |
| Premises and equipment, net | \$ 10,401    | \$ 10,393 |

Depreciation expense for the years ended December 2012, 2011 and 2010 amounted to \$764, \$799 and \$886, respectively.

The Company leases certain 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, 2012 are as follows: \$219 in 2013, \$185 in 2014, \$52 in 2015, \$22 in 2016 and \$0 thereafter.

#### Note 7: Deposits

The aggregate amounts of time deposits in denominations of \$100 or more at December 31, 2012 and 2011 were \$112,245 and \$127,881, respectively.

At December 31, 2012 the scheduled maturities of time deposits are as follows:

|            |            |
|------------|------------|
| 2013       | \$ 209,513 |
| 2014       | 35,761     |
| 2015       | 7,989      |
| 2016       | 9,801      |
| 2017       | 14,569     |
| Thereafter | 105        |
|            | \$ 277,738 |

At December 31, 2012 and 2011, overdraft demand deposits reclassified to loans totaled \$401 and \$341, 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 NBI, NBB and NBFS are participating employers. Eligible participants may contribute up to 100% of their total annual compensation to the plan, subject to certain limits based on federal tax laws. 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, 2012, 2011 and 2010, the Company contributed \$279, \$279 and \$277, respectively, to the plan.

#### Employee Stock Ownership Plan

The Company has a nonleveraged Employee Stock Ownership Plan (ESOP) which enables employees of NBI 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 NBI common stock. Contributions to the ESOP, which are not mandatory, are determined annually by the Board of Directors. Contribution expense amounted to \$370, \$420 and \$350 in the years ended December 31, 2012, 2011 and 2010, respectively. Dividends on ESOP shares are charged to retained earnings. As of December 31, 2012, the number of shares held by the ESOP was 263,033. 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 NBI 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 the Company 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 distribution.

### Salary Continuation Plan

The Company has a Salary Continuation Plan for certain key officers. The plan provides the participating officers with supplemental retirement income, payable for the greater of 15 years after retirement or the officer's lifetime. The expense accrued for the plans in 2012, 2011, and 2010, based on the present value of the retirement benefits, amounted to \$151, \$197, and \$216, respectively. The plan is unfunded. However bank-owned life insurance has been acquired on the life of the key employees in amounts sufficient to discharge the obligations of the agreement.

### 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. This resulted in a reduction in prior cost. Information pertaining to activity in the plan is as follows:

|  | 2012        | December 31,<br>2011 | 2010        |
|--|-------------|----------------------|-------------|
| <b>Change in benefit obligation</b>                                      |             |                      |             |
| Projected benefit obligation at beginning of year                        | \$ 15,808   | \$ 12,971            | \$ 11,598   |
| Service cost   | 468         | 435                  | 400         |
| Interest cost  | 738         | 704                  | 687         |
| Actuarial loss   | 1,554       | 2,001                | 958         |
| Benefits paid  | (514 )      | (303 )               | (672 )      |
| Projected benefit obligation at end of year                              | \$ 18,054   | \$ 15,808            | \$ 12,971   |
| <b>Change in plan assets</b>   |             |                      |             |
| Fair value of plan assets at beginning of year                           | \$ 13,326   | \$ 8,156             | \$ 7,461    |
| Actual return on plan assets   | 963         | 432                  | 782         |
| Employer contribution  | 550         | 5,041                | 585         |
| Benefits paid  | (514 )      | (303 )               | (672 )      |
| Fair value of plan assets at end of year                                 | \$ 14,325   | \$ 13,326            | \$ 8,156    |
| Funded status at the end of the year                                     | \$ (3,729 ) | \$ (2,482 )          | \$ (4,815 ) |
| <b>Amounts recognized in the Balance Sheet</b>                           |             |                      |             |
| Deferred tax asset   | \$ 1,305    | \$ 869               | \$ 1,685    |
| Other liabilities  | (3,729 )    | (2,482 )             | (4,815 )    |
| Total amounts recognized in the Balance Sheet                            | \$ (2,424 ) | \$ (1,613 )          | \$ (3,130 ) |
| <b>Amounts recognized in accumulated other comprehensive (loss), net</b> |             |                      |             |
| Net (loss)   | \$ (8,202 ) | \$ (7,044 )          | \$ (4,957 ) |
| Prior service cost   | 879         | 979                  | 1,080       |
| Deferred tax asset   | 2,563       | 2,123                | 1,357       |
| Amount recognized  | \$ (4,760 ) | \$ (3,942 )          | \$ (2,520 ) |

|   |    |           |    |           |    |           |
|---|----|-----------|----|-----------|----|-----------|
| Accrued/Prepaid benefit Cost, net   |    |           |    |           |    |           |
| Benefit obligation  | \$ | (18,054 ) | \$ | (15,808 ) | \$ | (12,971 ) |
| Fair value of assets  |    | 14,325    |    | 13,326    |    | 8,156     |
| Unrecognized net actuarial loss   |    | 8,202     |    | 7,044     |    | 4,957     |
| Unrecognized prior service cost   |    | (879 )    |    | (979 )    |    | (1,080 )  |
| Deferred tax asset (liability)  |    | (1,258 )  |    | (1,254 )  |    | 328       |
| (Accrued)/Prepaid benefit cost included in other liabilities  | \$ | 2,336     | \$ | 2,329     | \$ | (610 )    |
| Components of net periodic benefit cost   |    |           |    |           |    |           |
| Service cost  | \$ | 468       | \$ | 435       | \$ | 400       |
| Interest cost   |    | 738       |    | 704       |    | 687       |
| Expected return on plan assets  |    | (1,075 )  |    | (810 )    |    | (607 )    |
| Amortization of prior service cost  |    | (101 )    |    | (101 )    |    | (101 )    |
| Amortization of net obligation at transition  |    | ---       |    | ---       |    | (11 )     |
| Recognized net actuarial loss   |    | 508       |    | 292       |    | 246       |
| Net periodic benefit cost   | \$ | 538       | \$ | 520       | \$ | 614       |
| Other changes in plan assets and benefit obligations recognized in other comprehensive loss             |    |           |    |           |    |           |
| Net loss  | \$ | 1,157     | \$ | 2,087     | \$ | 536       |
| Amortization of prior service cost  |    | 101       |    | 101       |    | 101       |
| Amortization of net obligation at transition  |    | ---       |    | ---       |    | 11        |
| Deferred income tax (benefit)   |    | (440 )    |    | (766 )    |    | (227 )    |
| Total recognized  | \$ | 818       | \$ | 1,422     | \$ | 421       |
| Total recognized in net periodic benefit cost and other comprehensive loss, net of income tax (benefit) |    |           |    |           |    |           |
|   | \$ | 1,797     | \$ | 2,708     | \$ | 1,035     |
| Weighted average assumptions at end of the year   |    |           |    |           |    |           |
| Discount rate used for net periodic pension cost  |    | 4.50      | %  | 5.50      | %  | 6.00      |
| Discount rate used for disclosure   |    | 3.75      | %  | 4.50      | %  | 5.50      |
| Expected return on plan assets  |    | 8.00      | %  | 8.00      | %  | 8.00      |
| Rate of compensation increase   |    | 3.00      | %  | 3.00      | %  | 4.00      |

### 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 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 defined benefit 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. The Policy establishes quality standards for fixed income investments and mutual funds included in the pension plan trust. The Policy also outlines diversification standards.

The preferred target allocation for the assets of the defined benefit pension plan is 65% in equity securities and 35% in fixed income securities. Equity securities include investments in large-cap and mid-cap companies primarily located in the United States, although a small number of international large-cap companies are included. There are also investments in mutual funds holding the equities of large-cap and mid-cap U.S. companies. Fixed income securities include U.S. government agency securities and corporate bonds from companies representing diversified industries. There are no investments in hedge funds, private equity funds or real estate.

Fair value measurements of the pension plan's assets at December 31, 2012 follow:

| Asset Category                                  | Fair Value Measurements at December 31, 2012 |  |                                 |                                |  |
|---|--|--|---------------------------------|--------------------------------|--|
|   | Total  | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Inputs (Level 2) | Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Cash  | \$ 462                                       | \$ 462   | \$                              | ---                            | \$ ---   |
| Equity securities:                              |  |  |                                 |                                |  |
| U. S. companies                                 | 6,470  | 6,470  |                                 | ---                            | ---  |
| International companies                         | 112  | 112  |                                 | ---                            | ---  |
| Equities mutual funds (1)                       | 1,411  | 1,411  |                                 | ---                            | ---  |
| U. S. government<br>agencies and corporations   | 366  | ---  |                                 | 366                            | ---  |
| State and political<br>subdivisions             | 435  | ---  |                                 | 435                            | ---  |
| Corporate bonds –<br>investment grade (2)       | 4,956  | ---  |                                 | 4,956                          | ---  |
| Corporate bonds – below<br>investment grade (3) | 113  | ---  |                                 | 113                            | ---  |
| Total pension plan assets                       | \$ 14,325                                    | \$ 8,455   | \$                              | 5,870                          | \$ ---   |

(1) This category comprises actively managed equity funds invested in large-cap and mid-cap U.S. companies.

(2) This category represents investment grade bonds of U.S. issuers from diverse industries.

(3) This category represents bonds from U.S. issuers from diverse industries that were purchased at investment grade, but which have fallen below investment grade.

| Asset Category                                  | Fair Value Measurements at December 31, 2011 |  |                                 |                                |  |
|---|--|--|---------------------------------|--------------------------------|--|
|   | Total  | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Inputs (Level 2) | Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Cash  | \$ 2,802                                     | \$ 2,802   | \$                              | ---                            | \$ ---   |
| Equity securities:                              |  |  |                                 |                                |  |
| U. S. companies                                 | 4,793  | 4,793  |                                 | ---                            | ---  |
| International companies                         | 183  | 183  |                                 | ---                            | ---  |
| Equities mutual funds (1)                       | 1,228  | 1,228  |                                 | ---                            | ---  |
| U. S. government<br>agencies and corporations   | 510  | ---  |                                 | 510                            | ---  |
| State and political<br>subdivisions             | 418  | ---  |                                 | 418                            | ---  |
| Corporate bonds –<br>investment grade (2)       | 3,207  | ---  |                                 | 3,207                          | ---  |
| Corporate bonds – below<br>investment grade (3) | 185  | ---  |                                 | 185                            | ---  |
| Total pension plan assets                       | \$ 13,326                                    | \$ 9,006   | \$                              | 4,320                          | \$ ---   |

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- (1) This category comprises actively managed equity funds invested in large-cap and mid-cap U.S. companies.
- (2) This category represents investment grade bonds of U.S. issuers from diverse industries.
- (3) This category represents bonds from U.S. issuers from diverse industries that were purchased at investment grade, but which have fallen below investment grade.

The Company's required minimum pension contribution for 2013 has not yet been determined.

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

|             |          |
|-------------|----------|
| 2013        | \$ 3,438 |
| 2014        | \$ 934   |
| 2015        | \$ 609   |
| 2016        | \$ 1,272 |
| 2017        | \$ 1,562 |
| 2018 - 2022 | \$ 3,784 |



## Note 9: Stock Option Plan

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

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

| Options                          | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|--------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2012   | 77,000 | \$ 22.82                        |   |                           |
| Granted                          | ---    | ---                             |   |                           |
| Exercised                        | 8,000  | 14.83                           |   |                           |
| Forfeited or expired             | ---    | ---                             |   |                           |
| Outstanding at December 31, 2012 | 69,000 | \$ 23.75                        | 3.83  | \$ 596                    |
| Exercisable at December 31, 2012 | 69,000 | \$ 23.75                        | 3.83  | \$ 596                    |

There were 8,000 shares exercised in 2012 with an intrinsic value of \$141. For 2011 and 2010, the intrinsic value of shares exercised were \$85 and \$0, respectively. No tax benefit was recognized on shares exercised in any of these years.

## Note 10: Income Taxes

The Company files United States federal income tax returns, and Virginia and West Virginia state income tax returns. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2008.

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

|                          | Years ended December 31, |          |          |
|--------------------------|--------------------------|----------|----------|
|                          | 2012                     | 2011     | 2010     |
| Current                  | \$ 5,064                 | \$ 4,665 | \$ 3,660 |
| Deferred expense         | 181                      | 582      | 563      |
| Total income tax expense | \$ 5,245                 | \$ 5,247 | \$ 4,223 |

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, |          |          |
|--|--------------------------|----------|----------|
|  | 2012                     | 2011     | 2010     |
| Computed "expected" income tax expense | \$ 8,047                 | \$ 8,010 | \$ 6,927 |
| Tax-exempt interest income             | (2,554 )                 | (2,517 ) | (2,556 ) |
| Nondeductible interest expense         | 139                      | 146      | 195      |
| Other, net                             | (387 )                   | (392 )   | (343 )   |
| Reported income tax expense            | \$ 5,245                 | \$ 5,247 | \$ 4,223 |



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

|   | December 31, |           |
|---|--------------|-----------|
|   | 2012         | 2011      |
| Deferred tax assets:                                  |              |           |
| Allowance for loan losses and unearned fee income     | \$ 3,219     | \$ 3,159  |
| Valuation allowance on other real estate owned        | 73           | 210       |
| Deferred compensation and other liabilities           | 2,176        | 1,788     |
| Discount accretion of securities                      | 19           | ---       |
| Total deferred tax assets                             | \$ 5,487     | \$ 5,157  |
| Deferred tax liabilities:                             |              |           |
| Fixed assets  | \$ (317 )    | \$ (266 ) |
| Deposit intangibles                                   | (1,039 )     | (912 )    |
| Other   | (31 )        | (138 )    |
| Net unrealized gains on securities available for sale | (1,102 )     | (1,425 )  |
| Total deferred tax liabilities                        | (2,489 )     | (2,741 )  |
| Net deferred tax assets                               | \$ 2,998     | \$ 2,416  |

The Company has determined that a valuation allowance for the gross deferred tax assets is not necessary at December 31, 2012 and 2011 because the realization of all 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

The Company's principal source of funds for dividend payments is dividends received from its subsidiary bank. For the years ended December 31, 2012, 2011 and 2010, dividends received from subsidiary banks were \$7,639, \$7,258 and \$6,309, respectively.

Substantially all of Bankshares' retained earnings are undistributed earnings of its sole 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, 2012, retained net income, which was free of such restriction, amounted to approximately \$30,700.

#### 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 possible 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.

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, 2012 and 2011, that the Company and the bank meet all capital adequacy

requirements to which they are subject.

As of December 31, 2011, the most recent notifications from the Office of the Comptroller of the Currency 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 bank's category. The Company's and the bank's actual capital amounts and ratios as of December 31, 2012 and 2011 are also presented in the following tables.

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|  | Actual     |       | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|------------|-------|-----------------------------|-------|--|--------|
|  | Amount     | Ratio | Amount                      | Ratio | Amount   | Ratio  |
| December 31, 2012                        |            |       |                             |       |  |        |
| Total capital (to risk weighted assets)  |            |       |                             |       |  |        |
| NBI consolidated                         | \$ 151,824 | 22.4% | \$ 54,225                   | 8.00% | N/A  | N/A    |
| NBB                                      | 148,684    | 22.0% | 53,984                      | 8.00% | \$ 67,481  | 10.00% |
| Tier 1 capital (to risk weighted assets) |            |       |                             |       |  |        |
| NBI consolidated                         | \$ 143,472 | 21.2% | \$ 27,113                   | 4.00% | N/A  | N/A    |
| NBB                                      | 140,335    | 20.8% | 26,992                      | 4.00% | \$ 40,488  | 6.00%  |
| Tier 1 capital (to average assets)       |            |       |                             |       |  |        |
| NBI consolidated                         | \$ 143,472 | 13.3% | \$ 43,010                   | 4.00% | N/A  | N/A    |
| NBB                                      | 140,335    | 13.1% | 42,973                      | 4.00% | \$ 53,716  | 5.00%  |

|  | Actual     |       | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|-----------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                      | Ratio | Amount   | Ratio |
| December 31, 2011                        |            |       |                             |       |  |       |
| Total capital (to risk weighted assets)  |            |       |                             |       |  |       |
| NBI consolidated                         | \$ 140,228 | 20.9% | \$ 53,615                   | 8.0%  | N/A  | N/A   |
| NBB                                      | 136,932    | 20.5% | 53,348                      | 8.0%  | \$ 66,684  | 10.0% |
| Tier 1 capital (to risk weighted assets) |            |       |                             |       |  |       |
| NBI consolidated                         | \$ 132,160 | 19.7% | \$ 26,807                   | 4.0%  | N/A  | N/A   |
| NBB                                      | 128,864    | 19.3% | 26,674                      | 4.0%  | \$ 40,011  | 6.0%  |
| Tier 1 capital (to average assets)       |            |       |                             |       |  |       |
| NBI consolidated                         | \$ 132,160 | 12.7% | \$ 41,598                   | 4.0%  | N/A  | N/A   |
| NBB                                      | 128,864    | 12.5% | 41,293                      | 4.0%  | \$ 51,617  | 5.0%  |

Note 13: Condensed Financial Statements of Parent Company  
Financial information pertaining only to NBI (Parent) is as follows:

Condensed Balance Sheets

|                               | December 31, |       |
|-------------------------------|--------------|-------|
|                               | 2012         | 2011  |
| Assets                        |              |       |
| Cash due from subsidiaries    | \$ 21        | \$ 2  |
| Securities available for sale | 1,597        | 2,140 |

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|  |            |            |
|--|------------|------------|
| Investments in subsidiaries, at equity     | 148,443    | 139,267    |
| Refundable income taxes                    | 77         | ---        |
| Other assets                               | 635        | 570        |
| Total assets                               | \$ 150,773 | \$ 141,979 |
| Liabilities and Stockholders' Equity       |            |            |
| Other liabilities                          | \$ 664     | \$ 680     |
| Stockholders' equity                       | 150,109    | 141,299    |
| Total liabilities and stockholders' equity | \$ 150,773 | \$ 141,979 |

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| Condensed Statements of Income  | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2012                     | 2011      | 2010      |
| <b>Income</b>   |                          |           |           |
| Dividends from subsidiaries   | \$ 7,639                 | \$ 7,258  | \$ 6,309  |
| Interest on securities – taxable  | 5                        | 17        | 23        |
| Interest on securities – nontaxable   | 33                       | 42        | 44        |
| Other income  | 1,213                    | 1,210     | 1,157     |
|   | \$ 8,890                 | \$ 8,527  | \$ 7,533  |
| <b>Expenses</b>   |                          |           |           |
| Other expenses  | \$ 1,791                 | \$ 1,794  | \$ 1,756  |
| Income before income tax benefit and equity in undistributed net income of subsidiaries | 7,099                    | 6,733     | 5,777     |
| Applicable income tax benefit   | 136                      | 148       | 152       |
| Income before equity in undistributed net income of subsidiaries                        | 7,235                    | 6,881     | 5,929     |
| Equity in undistributed net income of subsidiaries                                      | 10,512                   | 10,757    | 9,640     |
| Net income  | \$ 17,747                | \$ 17,638 | \$ 15,569 |
| <b>Condensed Statements of Cash Flows</b>   |                          |           |           |
|   | Years ended December 31, |           |           |
|   | 2012                     | 2011      | 2010      |
| <b>Cash Flows from Operating Expenses</b>   |                          |           |           |
| Net income  | \$ 17,747                | \$ 17,638 | \$ 15,569 |
| Adjustments to reconcile net income to net cash provided by operating activities:       |                          |           |           |
| Equity in undistributed net income of subsidiaries                                      | (10,512 )                | (10,757 ) | (9,640 )  |
| Amortization of premiums and accretion of discounts, net                                | 1                        | 1         | 2         |
| Depreciation expense  | 12                       | 9         | 9         |
| Net change in refundable income taxes due from subsidiaries                             | 77                       | ---       | 56        |
| Net change in other assets  | (199 )                   | 147       | (24 )     |
| Net change in other liabilities   | (124 )                   | (364 )    | 244       |
| Net cash provided by operating activities   | 7,002                    | 6,674     | 6,216     |
| <b>Cash Flows from Investing Activities</b>   |                          |           |           |
| Purchases of securities available for sale  | (815 )                   | (1,973 )  | (1,868 )  |
| Maturities and calls of securities available for sale                                   | 1,352                    | 2,250     | 1,950     |
| Net cash provided by investing activities   | 537                      | 277       | 82        |
| <b>Cash Flows from Financing Activities</b>   |                          |           |           |
| Cash dividends paid   | (7,639 )                 | (6,938 )  | (6,309 )  |
| Exercise of stock options   | 119                      | 92        | ---       |
| Capital distribution to subsidiary  | ---                      | (105 )    | ---       |
| Net cash used in financing activities   | (7,520 )                 | (6,951 )  | (6,309 )  |
| Net change in cash  | 19                       | ---       | (11 )     |
| Cash due from subsidiaries at beginning of year   | 2                        | 2         | 13        |
| Cash due from subsidiaries at end of year   | \$ 21                    | \$ 2      | \$ 2      |





#### 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 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, 2012 and 2011, the following financial instruments were outstanding whose contract amounts represent credit risk:

|   | December 31, |            |
|---|--------------|------------|
|   | 2012         | 2011       |
| Financial instruments whose contract amounts represent credit risk: |              |            |
| Commitments to extend credit  | \$ 128,162   | \$ 130,369 |
| Standby letters of credit   | 12,533       | 13,206     |
| Mortgage loans sold with potential recourse                         | 22,574       | 13,419     |

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 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 2012, the Company originated \$22,747 and sold \$22,574 to investors, compared to \$13,582 originated and \$13,419 sold in 2011. 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, 2012, the Company had locked-rate commitments to originate mortgage loans amounting to approximately \$408 and loans held for sale of \$2,796. Risks arise from the possible inability of 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, 2012 that exceeded the insurance limits of the Federal Deposit Insurance Corporation was \$4. The FDIC's Transaction Account Guarantee Program ("TAG") provided unlimited coverage for noninterest bearing deposit accounts. The Company's deposits with other commercial banks were subject to the TAG coverage. The TAG

expired December 31, 2012. The Company does not expect that the expiration of the TAG program will significantly affect the off-balance sheet risk associated with its deposits in other commercial banks.

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 in southwest Virginia is made up of the counties of Montgomery, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It also includes the independent cities of Radford and Galax, and the portions of Carroll and Grayson Counties that are adjacent to Galax. In addition, it serves those portions of Mercer County and McDowell County, West Virginia that are contiguous with Tazewell County. Substantially all of NBB's loans are made in its market area. The ultimate collectability 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.

Commercial real estate as of December 31, 2012 and 2011 represented approximately 51% of the loan portfolio, at \$304,308 and \$303,192, respectively. Included in commercial real estate are loans for college housing and professional office buildings that comprised \$171,186 and \$166,710 as of December 31, 2012 and 2011 respectively, corresponding to approximately 29% of the loan portfolio at December 31, 2012 and 28% of the loan portfolio at December 31, 2011. Loans secured by residential real estate were approximately \$143,262, or 24% of the portfolio, and \$150,224, or 26% of the portfolio at December 31, 2012 and 2011, respectively. Loans secured by automobiles represented 2% of the portfolio for both dates, at \$11,764 and \$13,089 at December 31, 2012 and 2011, respectively. 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 Measurements

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

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

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

1 –

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

2 –

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

3 –

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

#### Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are

derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following tables present the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011:

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

| Description                               | Fair Value Measurements at December 31, 2011 |  |   |   |
|---|--|--|---|---|
|   | Balance as of December 31, 2011              | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Treasury                             | \$ 2,150                                     | \$ ---   | \$ 2,150                                      | \$ ---                                    |
| U.S. Government agencies and corporations | 96,003                                       | ---  | 96,003  | ---                                       |
| States and political subdivisions         | 49,122                                       | ---  | 49,122  | ---                                       |
| Mortgage-backed securities                | 7,725  | ---  | 7,725   | ---                                       |
| Corporate debt securities                 | 16,077                                       | ---  | 16,077  | ---                                       |
| Other securities                          | 2,175  | ---  | 2,175   | ---                                       |
| Total securities available for sale       | \$ 173,252                                   | \$ ---   | \$ 173,252                                    | \$ ---                                    |

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

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

#### Loans Held for Sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the

short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the years ended December 31, 2012 and 2011. Gains and losses on the sale of loans are recorded within other income from mortgage banking on the Consolidated Statements of Income.

#### Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due will not be collected according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan's balance exceeds fair value, the amount is allocated to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The fair value of an impaired loan and measurement of associated loss is based on one of three methods: the observable market price of the loan, the present value of projected cash flows, or the fair value of the collateral. The observable market price of a loan is categorized as a Level 1 input. The present value of projected cash flows method results in a Level 3 categorization because the calculation relies on the Company's judgment to determine projected cash flows, which are then discounted at the current rate of the loan, or the rate prior to modification if the loan is a troubled debt restructure.

Loans measured using the fair value of collateral method may be categorized in Level 2 or Level 3. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The value of real estate collateral that is determined by a current (less than 12 months of age) appraisal utilizing an income or market valuation approach conducted by an independent, licensed appraiser outside of the Company using observable market data is categorized as Level 2. If a current appraisal cannot be obtained prior to a reporting date and an existing appraisal is discounted to obtain an estimated value, or if declines in value are identified after the date of the appraisal, or if an appraisal is discounted for estimated selling costs, the valuation of real estate collateral is categorized as Level 3. The value of business equipment is based upon an outside appraisal (Level 2) if deemed significant, or the net book value on the applicable business' financial statements (Level 3) if not considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3).

As of December 31, 2012, the fair value measurements for impaired loans with specific allocations were primarily based upon the fair value of collateral, with one loan valued based on the present value of cash flows. Fair value measurements for impaired loans as of December 31, 2011 were based upon the collateral method.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the period.

| Date              | Description                                  | Balance | Carrying value  |   |  |
|-------------------|--|---------|---|---|--|
|                   |  |         | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                   | Assets:                                      |         |   |   |  |
| December 31, 2012 | Impaired loans net of<br>valuation allowance | \$ 362  | \$ ---  | \$ ---  | \$ 362   |
| December 31, 2011 | Impaired loans net of<br>valuation allowance | 5,968   | ---   | ---   | 5,968  |

Impaired loans are measured quarterly for impairment. The Company employs the most applicable valuation method for each loan based on current information at the time of valuation. The valuation procedures for 2012 resulted in changes in valuation method from collateral-based to the present value of cash flows for certain loans, reduced allocations for certain loans or required partial charge-offs to reduce certain collateral-dependent loans to fair value and in turn removed the specific allocation. The impaired loans removed from Level 3 as well as the change in balance for impairment allocation summarized above reflect the change in valuation method, updated fair values from newly obtained appraisals or projections, and resulting change in allocation for these loans.

Certain impaired loans were removed from Level 3 due to foreclosure or charge-off. One foreclosure resulted in an increase to the Company's other real estate owned. Certain unsecured loans were charged off, while the remaining foreclosures were secured by properties that were purchased by third parties at auction.

The following table presents information about Level 3 Fair Value Measurements for December 31, 2012.

| Valuation Technique | Unobservable Input | Range<br>(Weighted<br>Average) |
|---------------------|--------------------|--------------------------------|
|---------------------|--------------------|--------------------------------|

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|                |                             |   |                         |
|----------------|-----------------------------|---|-------------------------|
| Impaired loans | Discounted appraised value  | Selling cost  | 0% - 10.00%<br>(2.00%)  |
| Impaired loans | Discounted appraised value  | Discount for lack of marketability and age of appraisal | 0% - 60.00%<br>(52.00%) |
| Impaired loans | Present value of cash flows | Discount rate   | 6.00%(1)                |

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

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. Valuation of other real estate owned is determined using current appraisals from independent parties, a level two input. If current appraisals cannot be obtained prior to reporting dates, or if declines in value are identified after a recent appraisal is received, appraisal values are discounted, resulting in Level 3 estimates. If the Company markets the property with a realtor, estimated selling costs reduce the fair value, resulting in a valuation based on Level 3 inputs.



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

| Date              | Description  | Balance  | Carrying Value  |   |  |
|-------------------|--|----------|---|---|--|
|                   |  |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                   | Assets:  |          |   |   |  |
| December 31, 2012 | Other real estate<br>owned net of valuation<br>allowance | \$ 1,435 | \$ ---  | \$ ---  | \$ 1,435   |
| December 31, 2011 | Other real estate<br>owned net of valuation<br>allowance | 1,489    | ---   | ---   | 1,489  |

The following table presents information about Level 3 Fair Value Measurements for December 31, 2012.

|                         | Valuation Technique           | Unobservable Input   | Range<br>(Weighted<br>Average) |
|-------------------------|-------------------------------|--|--------------------------------|
| Other real estate owned | Discounted appraised<br>value | Selling cost   | 0.00%(1) - 6.00%<br>(4.30%)    |
| Other real estate owned | Discounted appraised<br>value | Discount for lack of marketability and<br>age of appraisal | 0.00% - 30.90%<br>(4.68%)      |

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

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

#### Cash and Due from Bank, and Interest-Bearing Deposits

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 determined within management's judgment, using available market information and specific borrower information.

#### Bank-Owned Life Insurance

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

#### 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, 2012 and 2011, and, as such, the related fair values have not been estimated.

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

|                              | Carrying<br>Amount | December 31, 2012<br>Estimated Fair Value |         |            |
|------------------------------|--------------------|---|---------|------------|
|                              |                    | Level 1                                   | Level 2 | Level 3    |
| Financial assets:            |                    |   |         |            |
| Cash and due from banks      | \$ 14,783          | \$ 14,783                                 | \$ ---  | \$ ---     |
| Interest-bearing deposits    | 96,597             | 96,597                                    | ---     | ---        |
| Securities                   | 352,043            | ---                                       | 362,350 | ---        |
| Mortgage loans held for sale | 2,796              | ---                                       | 2,796   | ---        |
| Loans, net                   | 583,813            | ---                                       | ---     | 570,471    |
| Accrued interest receivable  | 6,247              | ---                                       | 3,291   | 2,956      |
| Bank-owned life insurance    | 20,523             | 20,523                                    | ---     | ---        |
| Financial liabilities:       |                    |   |         |            |
| Deposits                     | \$ 946,766         | \$ 669,028                                | \$ ---  | \$ 272,820 |
| Accrued interest payable     | 139                | 41  | ---     | 98         |

|                              | Carrying<br>Amount | December 31, 2011<br>Estimated Fair Value |                         |
|------------------------------|--------------------|---|-------------------------|
|                              |                    | Carrying<br>Amount                        | Estimated Fair<br>Value |
| Financial assets:            |                    |   |                         |
| Cash and due from banks      | \$ 11,897          | \$ 11,897                                 | \$ 11,897               |
| Interest-bearing deposits    | 98,355             | 98,355                                    | 98,355                  |
| Securities                   | 318,913            | 326,347                                   | 326,347                 |
| Mortgage loans held for sale | 2,623              | 2,623                                     | 2,623                   |
| Loans, net                   | 580,402            | 572,357                                   | 572,357                 |
| Accrued interest receivable  | 6,304              | 6,304                                     | 6,304                   |
| Bank-owned life insurance    | 19,812             | 19,812                                    | 19,812                  |
| Financial liabilities:       |                    |   |                         |
| Deposits                     | \$ 919,333         | \$ 913,882                                | \$ 913,882              |
| Accrued interest payable     | 206                | 206                                       | 206                     |

## Note 17: Components of Accumulated Other Comprehensive Income

|   | Net<br>Unrealized<br>Gain (Loss)<br>on Securities | Adjustments<br>Related to<br>Pension<br>Benefits | Accumulated<br>Other<br>Comprehensive<br>(Loss) |
|---|---|--|---|
| Balance at December 31, 2009  | \$ 1,632  | \$ (2,124)                                       | \$ (492)  |
| Unrealized holding loss on available for sale securities net of tax of (\$923)                      | (1,716)   | ---  | (1,716)   |
| Reclassification adjustment, net of tax of (\$7)  | (12)  | ---  | (12)  |
| Net pension loss arising during the period, net of tax of (\$188)                                   | ---   | (348)  | (348)   |
| Less amortization of prior service cost included in net periodic pension cost, net of tax of (\$39) | ---   | (73)   | (73)  |
| Balance at December 31, 2010  | (96)  | (2,545)  | (2,641)   |
| Unrealized holding gain on available for sale securities net of tax of \$1,468                      | 2,725   | ---  | 2,725   |
| Reclassification adjustment, net of tax of \$9  | 17  | ---  | 17  |
| Net pension loss arising during the period, net of tax of (\$731)                                   | ---   | (1,356)  | (1,356)   |
| Less amortization of prior service cost included in net periodic pension cost, net of tax of (\$35) | ---   | (66)   | (66)  |
| Balance at December 31, 2011  | 2,646   | (3,967)  | (1,321)   |
| Unrealized holding loss on available for sale securities net of tax of (\$320)                      | (592)   | ---  | (592)   |
| Reclassification adjustment, net of tax of (\$3)  | (7)   | ---  | (7)   |
| Net pension loss arising during the period, net of tax of (\$405)                                   | ---   | (752)  | (752)   |
| Less amortization of prior service cost included in net periodic pension cost, net of tax of (\$35) | ---   | (66)   | (66)  |
| Balance at December 31, 2012  | \$ 2,047  | \$ (4,785)                                       | \$ (2,738)                                      |

## Note 18. Intangible Assets and Goodwill

In accounting for goodwill and intangible assets, the Company conducts an impairment review at least annually and more frequently if certain impairment indicators are in evidence. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. If the preliminary assessment indicates that it is more likely than not that fair value is below carrying value, a two-step test is employed to determine impairment. The Company opted not to perform the preliminary assessment and employed the two-step test to determine impairment. Based on the testing for impairment of goodwill and intangible assets, there were no impairment charges for 2012, 2011 or 2010.

Information concerning goodwill and intangible assets for years ended December 31, 2012 and 2011 is presented in the following table:

|                                      | Gross<br>Carrying<br>Value | Accumulated<br>Amortization | Net Carrying<br>Value |
|--------------------------------------|----------------------------|-----------------------------|-----------------------|
| December 31, 2012                    |                            |                             |                       |
| Amortizable core deposit intangibles | \$ 16,257                  | \$ 12,728                   | \$ 3,529              |
| Unamortizable goodwill               | \$ 5,848                   | \$ ---                      | \$ 5,848              |
| December 31, 2011                    |                            |                             |                       |
| Amortizable core deposit intangibles | \$ 16,257                  | \$ 11,645                   | \$ 4,612              |
| Unamortizable goodwill               | \$ 5,848                   | \$ ---                      | \$ 5,848              |

As of December 31, 2012, the estimated amortization expense of core deposit intangibles are as follows:

|            |          |
|------------|----------|
| 2013       | \$ 1,075 |
| 2014       | 1,075    |
| 2015       | 999      |
| 2016       | 257      |
| Thereafter | 123      |
| Total      | \$ 3,529 |

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, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), National Bankshares, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 8, 2013 expressed an unqualified opinion on the effectiveness of National Bankshares, Inc. and subsidiaries' internal control over financial reporting.

Winchester, Virginia  
March 8, 2013

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited National Bankshares, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. National Bankshares, Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) 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 (c) 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.

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, National Bankshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.





We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2012 of National Bankshares, Inc. and subsidiaries and our report dated March 8, 2013 expressed an unqualified opinion.

Winchester, Virginia  
March 8, 2013

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

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of December 31, 2012 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the year ended December 31, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

Internal Control Over Financial Reporting

Management's Report on Internal Control Over Financial Reporting

To the Stockholders of 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, 2012. 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, 2012.

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 registered public accounting firm and approves decisions regarding the appointment or removal of the Company Auditor. It meets periodically with management, the independent registered public accounting firm 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 registered public accounting firm 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. The Company's independent registered public accounting firm has also issued an attestation report on the effectiveness of internal control over financial reporting.

/s/ JAMES G. RAKES  
Chairman, President and  
Chief Executive Officer

/s/ DAVID K. SKEENS  
Treasurer and  
Chief Financial Officer

## Item 9B. Other Information

## Subsequent Events

From December 31, 2012, the balance sheet date of this Form 10-K, through the date of filing of the Form 10-K with the Securities and Exchange Commission, there have been no material subsequent events that 1) provide additional evidence about conditions that existed on the date of the balance sheet, or 2) provides evidence about conditions that did not exist at the date of the balance sheet, but arose after the balance sheet date.

## 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” of Bankshares’ Proxy Statement dated March 8, 2013 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 Listing Rules. In 2012, Dr. J. M. Lewis chaired the Audit Committee and its members were Mr. L. J. Ball, Mr. J. W. Bowling, Dr. J. E. Dooley and Mr. C. E. Green, III. Mr. Bowling served on the Committee until his death in May 2012. Dr. Dooley joined the Committee in November 2012. 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.

| Name            | Age | Offices and Positions Held  | Year Elected an Officer/Director |
|-----------------|-----|---|----------------------------------|
| James G. Rakes  | 68  | Chairman, President and Chief Executive Officer, National Bankshares, Inc.; President and Chief Executive Officer of National Bank of Blacksburg since 1983 and Chairman since 2005. Chairman, President and CEO of National Bankshares Financial Services, Inc. since June 1, 2011; prior thereto Chairman, President and Treasurer since 2001.  | 1986                             |
| David K. Skeens | 46  | Treasurer and Chief Financial Officer of National Bankshares, Inc. since January 14, 2009; Senior Vice President/Operations & Risk Management & CFO of National Bank of Blacksburg since 2009; prior thereto Senior Vice President/Operations & Risk Management since 2008; prior thereto Vice President/Operations & Risk Management since 2004. | 2009                             |
| F. Brad Denardo | 60  | Executive Vice President, National Bankshares, Inc. since 2008; Interim Treasurer and Chief Financial Officer from May 23, 2008 to January 14, 2009; prior  | 1989                             |

|                  |    |   |      |
|------------------|----|---|------|
|                  |    | thereto Corporate Officer since 1989; Executive Vice President/Chief Operating Officer of National Bank of Blacksburg since 2002; Treasurer of National Bankshares Financial Services, Inc. since June 1, 2011.   |      |
| Bryson J. Hunter | 45 | Secretary & Counsel, National Bankshares, Inc. since July 1, 2011; Counsel of National Bank of Blacksburg since May 18, 2011. Secretary & Counsel of National Bankshares Financial Services, Inc. since June 1, 2011; prior thereto Partner, Gentry Locke Rakes & Moore, LLP since 2008; prior thereto Associate, Gentry Locke Rakes & Moore, LLP since 2001. | 2011 |

## Item 11. Executive Compensation

The information set forth under “Executive Compensation” on pages 11 through 18 of NBI’s Proxy Statement dated March 8, 2013 is incorporated herein by reference.

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

The information contained under “Stock Ownership of Directors and Executive Officers” on page 2 of NBI’s Proxy Statement dated March 8, 2013 for the Annual Meeting of Stockholders to be held April 9, 2013 is incorporated herein by reference.

The following table summarizes information concerning National Bankshares equity compensation plans at December 31, 2012:

| Plan Category   | Number of Shares to be Issued upon Exercise of Outstanding Options and Warrants | Weighted Average Exercise Price of Outstanding Options and Warrants | Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Shares Reflected in First Column) |
|---|---|---|---|
| Equity compensation plans approved by stockholders 1999 Stock Option Plan | 69,000  | \$ 23.75  | ---   |
| Equity compensation plans not approved by stockholders                    | ---   | ---   | ---   |
| <b>Total</b>  | <b>69,000</b>   | <b>\$ 23.75</b>   | <b>---</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 pages 6 and 7 of NBI’s Proxy Statement dated March 8, 2013 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 NBI for the years ended December 31, 2012 and 2011. 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.

## Principal Accounting Fees and Services

|      | 2012       |      | 2011       |  |
|------|------------|------|------------|--|
| Fees | Percentage | Fees | Percentage |  |

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|                    |    |         |      |    |         |      |
|--------------------|----|---------|------|----|---------|------|
| Audit fees         | \$ | 112,00  | 77%  | \$ | 108,750 | 77%  |
| Audit-related fees |    | 26,250  | 18%  |    | 24,950  | 18%  |
| Tax fees           |    | 7,750   | 5%   |    | 7,500   | 5%   |
|                    | \$ | 146,000 | 100% | \$ | 141,200 | 100% |

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

Audit-related fees: Employee benefit plan audits 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.

## 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:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets – As of December 31, 2012 and 2011

Consolidated Statements of Income – Years ended December 31, 2012, 2011 and 2010

Consolidated Statements of Comprehensive Income – Years ended December 31, 2012, 2011 and 2010

Consolidated Statements of Changes in Stockholders' Equity – Years ended December 31, 2012, 2011 and 2010

Consolidated Statements of Cash Flows – Years ended December 31, 2012, 2011 and 2010

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:

| Exhibit No. | Description  | Page No. in Sequential System  |
|-------------|--|--|
| 3(i)        | Amended and Restated Articles of Incorporation of National Bankshares, Inc.                                  | (incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)   |
| 3(ii)       | Amended By-laws of National Bankshares, Inc.   | (incorporated herein by reference to Exhibit 3(ii) of the Annual Report on Form 10K for fiscal year ended December 31, 2007)               |
| 4(i)        | Specimen copy of certificate for National Bankshares, Inc. common stock                                      | (incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)                |
| *10(iii)(A) | National Bankshares, Inc. 1999 Stock Option Plan   | (incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999) |
| *10(iii)(A) | Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and James G. Rakes | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)          |
| *10(iii)(A) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National           | (incorporated herein by reference to Exhibit 10 (iii) (A) of Form  |



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Bank of Blacksburg

10Q for the period ended  
September 30, 2002)

|             |  |   |
|-------------|--|---|
| *10(iii)(A) | Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and F. Brad Denardo        | (incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for fiscal year ended December 31, 2008) |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes     | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)                                 |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo    | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)                                 |
| *10(iii)(A) | Salary Continuation Agreement dated February 8, 2006, between<br>The National Bank of Blacksburg and David K. Skeens | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                 |

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|              |  |  |
|--------------|--|--|
| *10(iii)(A)  | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)                                 |
| *10(iii)(A)  | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)                                 |
| *10(iii)(A)  | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                  |
| *10(viii)(A) | Second Amendment, dated June 12, 2008, to The 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 June 12, 2008)                                     |
| *10(viii)(A) | Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes   | (incorporated herein by reference to Exhibit 10(viii)(A) of the Annual Report on Form 10K for fiscal year ended December 31, 2008) |
| *10(iii)(A)  | Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens  | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                  |
| *10(viii)(A) | Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo   | (incorporated herein by reference to Exhibit 10(viii)(A) of the Annual Report on Form 10K for fiscal year ended December 31, 2008) |
| *10(iii)(A)  | Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                  |
| *10(iii)(A)  | Salary Continuation Agreement dated January 20, 2012 between<br>The National Bank of Blacksburg and Bryson J. Hunter   | (incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)                                  |
| +21          | Subsidiaries of the Registrant   | Included herein  |
| +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  | (incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2012)          |
| +31(i)       | Section 906 Certification of Chief Executive Officer   | Page 92  |
| +31(ii)      | Section 906 Certification of Chief Financial Officer   | Page 93  |
| +32(i)       | 18 U.S.C. Section 1350 Certification of Chief Executive Officer  | Page 95  |
| +32(ii)      | 18 U.S.C. Section 1350 Certification of Chief Financial Officer  | Page 95  |
| +101         | The following materials from National Bankshares, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2012, formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements | Included herein  |

of Changes in Shareholders' Equity, (iv) Consolidated  
Statements of Cash Flows, and (v) Notes to  
Consolidated Financial Statements.

\*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 and Chief Executive  
Officer

(Principal Executive Officer)

/s/ DAVID K. SKEENS

David K. Skeens

Treasurer and Chief Financial Officer

(Principal Financial Officer)

(Principal Accounting Officer)

Date: March 8, 2013

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; 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 purposes in accordance with generally accepted accounting principles; and
  - (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.
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 8, 2013

/s/ JAMES G. RAKES

James G. Rakes

Chairman, President and Chief Executive  
Officer

(Principal Executive Officer)

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Exhibit 31(ii)

I, David K. Skeens, Treasurer and 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; and
  - (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.
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 8, 2013

/s/ DAVID K. SKEENS  
David K. Skeens  
Treasurer and  
Chief Financial Officer  
(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.

|  | Date      | Title   |
|--|-----------|---|
| /s/ L. J. BALL<br>L. J. Ball             | 03/8/2013 | Director  |
| /s/ J. E. DOOLEY<br>J. E. Dooley         | 03/8/2013 | Director  |
| /s/ C. E. GREEN, III<br>C. E. Green, III | 03/8/2013 | Director  |
| /s/ J. M. LEWIS<br>J. M. Lewis           | 03/8/2013 | Director  |
| /s/ M. G. MILLER<br>M. G. Miller         | 03/8/2013 | Director  |
| /s/ W. A. PEERY<br>W. A. Peery           | 03/8/2013 | Director  |
| /s/ J. G. RAKES<br>J. G. Rakes           | 03/8/2013 | Chairman of the Board<br>President and Chief Executive Officer –<br>National Bankshares, Inc.<br>Director |
| /s/ G. P. REYNOLDS<br>G. P. Reynolds     | 03/8/2013 | Director  |
| /s/ J. M. SHULER<br>J. M. Shuler         | 03/8/2013 | Director  |

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, 2012, 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, 2012, 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, 2012, 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 U.S.C. SECTION 1350

In connection with the Form 10-K of National Bankshares, Inc. for the year ended December 31, 2012, I, David K. Skeens, Treasurer and Chief 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-K for the year ended December 31, 2012, 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, 2012, fairly presents in all material respects, the financial condition and results of operations of National Bankshares, Inc.

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

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Index of Exhibits

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

| Exhibit No. | Title   | Page Number |
|-------------|---|-------------|
| 31(i)       | Section 906 Certification of Chief Executive Officer            | Page 92     |
| 31(ii)      | Section 906 Certification of Chief Financial Officer            | Page 93     |
| 32(i)       | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | Page 95     |
| 32(ii)      | 18 U.S.C. Section 1350 Certification of Chief Financial Officer | Page 95     |

