NATIONAL BANKSHARES INC
Form 10-Q
May 09, 2012

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

FORM 10-Q

[x]QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 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 or other jurisdiction of incorporation or organization)	54-1375874 (I.R.S. Employer Identification No.)
101 Hubbard Street P. O. Box 90002 Blacksburg, VA (Address of principal executive offices)	24062-9002 (Zip Code)

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

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

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

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

Large accelerated filer [ ] Accelerated filer [x] Non-accelerated filer [ ] Smaller reporting company [ ]
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b–2 of the Exchange Act).
[ ] Yes [x] No

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

Class	Outstanding at May 1, 2012
Common Stock, $1.25 Par Value	6,939,974

(This report contains 46 pages)

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

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Part I

Item 1. Financial Statements Financial Information

National Bankshares, Inc. and Subsidiaries

Consolidated Balance Sheets

$ in thousands, except per share data	(Unaudited) March 31, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 12,241	$ 11,897
Interest-bearing deposits	101,301	98,355
Securities available for sale, at fair value	198,346	174,918
Securities held to maturity (fair value approximates $147,509 at March 31, 2012 and $151,429 at December 31, 2011)	139,367	143,995
Mortgage loans held for sale	1,371	2,623
Loans:		
Loans, net of unearned income and deferred fees	584,564	588,470
Less allowance for loan losses	(8,063)	(8,068)
Loans, net	576,501	580,402
Premises and equipment, net	10,563	10,393
Accrued interest receivable	6,175	6,304
Other real estate owned, net	940	1,489
Intangible assets and goodwill	10,189	10,460
Bank-owned life insurance	19,991	19,812
Other assets	6,857	6,454
Total assets	$ 1,083,842	$ 1,067,102
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	$ 145,070	$ 142,163
Interest-bearing demand deposits	415,352	404,801
Savings deposits	65,322	61,298
Time deposits	306,048	311,071
Total deposits	931,792	919,333
Accrued interest payable	191	206
Other liabilities	7,067	6,264
Total liabilities	939,050	925,803
Commitments and contingencies	---	---
Stockholders' Equity		
Preferred stock, no par value, 5,000,000 sharesauthorized;		
none issued and outstanding	---	---
Common stock of $1.25 par value.		
Authorized 10,000,000 shares; issued and outstanding 6,939,974 shares at March 31, 2012 and 6,939,974 shares at December 31, 2011	8,675	8,675
Retained earnings	138,374	133,945
Accumulated other comprehensive loss, net	(2,257)	(1,321)
Total stockholders' equity	144,792	141,299
Total liabilities and stockholders' equity	$ 1,083,842	$ 1,067,102

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
Three Months Ended March 31, 2012 and 2011
(Unaudited)

$ in thousands, except per share data	March 31, 2012	March 31, 2011
Interest Income		
Interest and fees on loans	$ 8,878	$ 9,095
Interest on interest-bearing deposits	71	32
Interest on securities – taxable	1,589	1,662
Interest on securities – nontaxable	1,576	1,676
Total interest income	12,114	12,465
Interest Expense		
Interest on time deposits of $100,000 or more	425	561
Interest on other deposits	1,692	1,818
Total interest expense	2,117	2,379
Net interest income	9,997	10,086
Provision for loan losses	672	800
Net interest income after provision for loan losses	9,325	9,286
Noninterest Income		
Service charges on deposit accounts	631	612
Other service charges and fees	49	58
Credit card fees	794	733
Trust income	326	246
BOLI income	200	184
Other income	99	91
Realized securities gains, net	53	10
Total noninterest income	2,152	1,934
Noninterest Expense		
Salaries and employee benefits	2,956	2,904
Occupancy and furniture and fixtures	397	423
Data processing and ATM	392	444
FDIC assessment	109	346
Credit card processing	572	586
Intangible assets amortization	271	271
Net costs of other real estate owned	48	134
Franchise taxes	162	242
Other operating expenses	804	734
Total noninterest expense	5,711	6,084
Income before income taxes	5,766	5,136
Income tax expense	1,337	1,112
Net Income	$ 4,429	$ 4,024

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Basic net income per share	$	0.64	$	0.58
Fully diluted net income per share	$	0.64	$	0.58
Weighted average number of common shares outstanding – basic		6,939,974		6,933,780
Weighted average number of common shares outstanding – diluted		6,954,637		6,957,450
Dividends declared per share	$	---	$	---

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income
Three Months Ended March 31, 2012 and 2011
(Unaudited)

$ in thousands	March 31, 2012	March 31, 2011
Net Income	$ 4,429	$ 4,024
Other Comprehensive Income, Net of Tax		
Unrealized holding gains (losses) on available for sale securities net of taxes of ($489) and $228 for the periods ended March 31, 2012 and 2011, respectively	(907)	423
Reclassification adjustment, net of taxes of ($15) and ($3) for the periods ended March 31, 2012 and 2011, respectively	(29)	(5)
Other comprehensive income (loss), net of taxes of ($504) and $225 for the periods ended March 31, 2012 and 2011, respectively	(936)	418
Total Comprehensive Income	$ 3,493	$ 4,442

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity
Three Months Ended March 31, 2012 and 2011
(Unaudited)

$ in thousands	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balances at December 31, 2010	$8,667	$123,161	$ (2,641)	$129,187
Net income	---	4,024	---	4,024
Stock options exercised	3	33	---	36
Other comprehensive income, net of tax $225	---	---	418	418
Balances at March 31, 2011	$8,670	$127,218	$ (2,223)	$133,665
Balances at December 31, 2011	$8,675	$133,945	$ (1,321)	$141,299
Net income	---	4,429	---	4,429
Other comprehensive loss, net of tax ($504)	---	---	(936)	(936)
Balances at March 31, 2012	$8,675	$138,374	$ (2,257)	$144,792

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Three Months Ended March 31, 2012 and 2011
(Unaudited)

$ in thousands	March 31, 2012	March 31, 2011
Cash Flows from Operating Activities		
Net income	$4,429	$4,024
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	672	800
Depreciation of bank premises and equipment	192	209
Amortization of intangibles	271	271
Amortization of premiums and accretion of discounts, net	56	61
Losses on sales and calls of securities available for sale, net	(44)	(8)
Gains on calls of securities held to maturity, net	(9)	(2)
Losses and write-downs on other real estate owned	(24)	100
Net change in:		
Mortgage loans held for sale	1,252	2,460
Accrued interest receivable	129	(498)
Other assets	(55)	228
Accrued interest payable	(15)	3
Other liabilities	803	(1,368)
Net cash provided by operating activities	7,657	6,280
Cash Flows from Investing Activities		
Net change interest-bearing deposits	(2,946)	13,726
Proceeds from calls, principal payments, sales and maturities of securities available for sale	41,168	10,659
Proceeds from calls, principal payments and maturities of securities held to maturity	13,846	5,449
Purchases of securities available for sale	(66,041)	(16,000)
Purchases of securities held to maturity	(9,239)	(7,138)
Collections of loan participations	90	25
Loan originations and principal collections, net	3,116	(12,622)
Proceeds from disposal of other real estate owned	573	295
Recoveries on loans charged off	23	25
Additions to bank premises and equipment	(362)	(105)
Net cash used in investing activities	(19,772)	(5,686)
Cash Flows from Financing Activities		
Net change in time deposits	(5,023)	(13,820)
Net change in other deposits	17,482	15,132
Stock options exercised	---	36
Net cash provided by financing activities	12,459	1,348
Net change in cash and due from banks	344	1,942
Cash and due from banks at beginning of period	11,897	9,858
Cash and due from banks at end of period	$12,241	$11,800

Supplemental Disclosures of Cash Flow Information		
Interest paid on deposits and borrowed funds	$2,132	$2,376
Income taxes paid	196	---
Supplemental Disclosure of Noncash Activities		
Loans charged against the allowance for loan losses	$700	$243
Loans transferred to other real estate owned	---	894
Unrealized gains (losses) on securities available for sale	(1,440)	643

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
March 31, 2012
(Unaudited)

$ in thousands, except per share data

Note 1: General

The consolidated financial statements of National Bankshares, Inc. ("NBI") and its wholly-owned subsidiaries, The National Bank of Blacksburg ("NBB") and National Bankshares Financial Services, Inc. ("NBFS") (collectively, the "Company"), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three months ended March 31, 2012 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company's 2011 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at www.nationalbankshares.com.
Subsequent events have been considered through the date when the Form 10-Q was issued.

Note 2: Stock-Based Compensation

The Company had a stock option plan, the 1999 Stock Option Plan, that was adopted in 1999 and that was terminated on March 9, 2009. 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.

Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2012	77,000	$22.82		
Exercised	---	---		
Forfeited or expired	---	---		
Outstanding March 31, 2012	77,000	$22.82	4.37	$560
Exercisable at March 31, 2012	77,000	$22.82	4.37	$560

There were no stock options exercised during the three months ended March 31, 2012. There were 2,500 shares with an intrinsic value of $35 exercised during the first quarter of 2011.

Note 3: Loan Portfolio

The loan portfolio, excluding loans held for sale, was comprised of the following:

	March 31, 2012	December 31, 2011

Real Estate Construction	$48,266	$48,528
Consumer Real Estate	147,312	149,750
Commercial Real Estate	301,911	303,192
Commercial Non Real Estate	39,998	38,849
Public Sector and IDA	15,263	15,407
Consumer Non Real Estate	31,814	32,744
Total	$584,564	$588,470

Note 4: 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 2011 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 or for which decreased cash flows indicate a decline in fair value are charged down to fair value.

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 the first quarter of 2012 are as follows.

Real Estate Construction
Construction, residential
Construction, other

Consumer Real Estate
Equity lines
Residential closed-end first liens
Residential closed-end junior liens

Commercial Real Estate
Multifamily real estate

Commercial Non Real Estate
Commercial and Industrial

Public Sector and IDA
Public sector and IDA

Consumer Non Real Estate
Credit cards
Automobile
Other consumer loans

Commercial real estate, owner occupied
Commercial real estate, other

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

Consumer Real Estate
Equity lines
Closed-end consumer real estate
Consumer construction

Consumer, Non Real Estate
Credit cards
Consumer, general
Consumer overdraft

Commercial & Industrial
Commercial & industrial

Construction, Development and Land
Residential
Commercial

Commercial Real Estate
College housing
Office/Retail space
Nursing homes
Hotels
Municipalities
Medical professionals
Religious organizations
Convenience stores
Entertainment and sports
Nonprofits
Restaurants
General contractors
Other commercial real estate

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.

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 for the three months ended March 31, 2012

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2011	$ 1,079	$ 1,245	$ 3,515	$ 1,473	$ 232	$ 403	$ 121	$ 8,068
Charge-offs	---	(95)	(537)	---	---	(68)	---	(700)
Recoveries	---	---	---	---	---	23	---	23
Provision for loan losses	(405)	1,102	242	(347)	(147)	124	103	672
Balance, March 31, 2012	$ 674	$ 2,252	$ 3,220	$ 1,126	$ 85	$ 482	$ 224	$ 8,063

Activity in the Allowance for Loan Losses for the three months ended March 31, 2011

	Consumer Real	Consumer Non Real	Commercial Real	Commercial &	Construction, Development	Unallocated	Total

	Estate	Estate	Estate	Industrial	& Other Land		
Balance, December 31, 2010	$ 1,059	$ 586	$ 4,033	$ 1,108	$ 749	$ 129	$ 7,664
Charge-offs	(36)	(90)	(118)	---	---	---	(244)
Recoveries	7	18	---	---	---	---	25
Provision for loan losses	72	(50)	740	113	(59)	(16)	800
Balance, March 31, 2011	$ 1,102	$ 464	$ 4,655	$ 1,221	$ 690	$ 113	$ 8,245

Allowance for Loan Losses as of March 31, 2012

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$ 13	$ 169	$ 42	$ 361	$ ---	$ 8	$ ---	$ 593
Collectively evaluated for impairment	661	2,083	3,178	765	85	474	224	7,470
Total	$ 674	$ 2,252	$ 3,220	$ 1,126	$ 85	$ 482	$ 224	$ 8,063

Allowance for Loan Losses as of December 31, 2011

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

Loans as of March 31, 2012

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	$ 6,367	$ 1,055	$ 4,849	$ 649	$ ---	$ 67	$ ---	$ 12,987
Collectively evaluated for impairment	41,899	146,257	297,062	39,349	15,263	31,747	---	571,577
Total	$ 48,266	$ 147,312	$ 301,911	$ 39,998	$ 15,263	$ 31,814	$ ---	$ 584,564

Loans as of December 31, 2011

	Consumer Real Estate	Consumer Non Real Estate	Commercial Real Estate	Commercial & Industrial	Construction, Development & Other Land	Unallocated	Total
Individually evaluated for impairment	$238	$---	$9,067	$139	$ 3,152	$---	$12,596
Collectively evaluated for impairment	109,843	29,707	357,507	37,584	41,233	---	575,874

Total	$110,081	$29,707	$366,574	$37,723	$44,385	$---	$588,470

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

	Three Months ended March 31, 2012	Three Months ended March 31, 2011	Year ended December 31, 2011
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees	1.38%	1.40%	1.37%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees(1)	0.46%	0.15%	0.43%

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

A summary of nonperforming assets follows:

	March 31, 2012	March 31, 2011	December 31, 2011
Nonperforming assets:			
Nonaccrual loans	$ 1,789	$ 2,339	$ 1,398
Restructured loans in nonaccrual	3,539	5,314	3,806
Total nonperforming loans	5,328	7,653	5,204
Other real estate owned, net	940	2,222	1,489
Total nonperforming assets	$ 6,268	$ 9,875	$ 6,693
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	1.07 %	1.67 %	1.13 %
Ratio of allowance for loan losses to nonperforming loans(1)	151.33 %	107.74 %	155.03 %

(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:

	March 31, 2012	March 31, 2011	December 31, 2011
Loans past due 90 days or more and still accruing	$ 210	$ 1,078	$ 481
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees	0.04 %	0.18 %	0.08 %
Accruing restructured loans	$ 3,742	$ 884	$ 3,756
Impaired loans:			
Impaired loans with no valuation allowance	$ 9,933	$ ---	$ 5,505
Impaired loans with a valuation allowance	3,054	7,084	7,091
Total impaired loans	$ 12,987	$ 7,084	$ 12,596
Valuation allowance	(593)	(1,256)	(1,123)
Impaired loans, net of allowance	$ 12,394	$ 5,828	$ 11,473
Average recorded investment in impaired loans(1)	$ 14,555	$ 7,690	$ 8,734
Interest income recognized on impaired loans, after designation as impaired	$ 24	$ 20	$ 141
Amount of income recognized on a cash basis	$ ---	$ ---	$ ---

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

Nonaccrual loans that meet the Company’s balance thresholds are designated as impaired. No interest income was recognized on nonaccrual loans for the three months ended March 31, 2012 and March 31, 2011, respectively.

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

	Impaired Loans as of March 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
Real Estate Construction					
Construction, residential	$1,256	$ 1,251	$1,251	$---	$---
Construction, other	5,111	5,102	3,480	1,622	13
Consumer Real Estate					
Equity lines	---	---	---	---	---
Residential closed-end first liens	798	800	525	275	60
Residential closed-end junior liens	257	258	110	148	109
Commercial Real Estate					
Multifamily real estate	529	529	529	---	---
Commercial real estate, owner occupied	4,320	4,334	3,909	425	42
Commercial real estate, other	---	---	---	---	---
Commercial Non Real Estate					
Commercial and industrial	649	649	121	528	361
Public Sector and IDA					
Public sector and IDA	---	---	---	---	---
Consumer Non Real Estate					
Credit cards	---	---	---	---	---
Automobile	---	---	---	---	---
Other consumer loans	67	67	---	67	8
Total	$12,987	$ 12,990	$9,925	$3,065	$593

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

	Impaired Loans as of December 31, 2011				
	Unpaid 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
Consumer Real Estate(2)					
Closed-end Consumer Real Estate	$237	$ 237	$237	$---	$---
Commercial Real Estate(2)					
College Housing	366	366	366	---	---
Office & 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
Commercial & Industrial(2)					
Commercial & Industrial	139	139	---	139	62
Construction, Development and Land(2)					
Residential	2,901	2,912	1,256	1,656	46
Commercial	252	252	252	---	---
Total	$12,596	$ 12,608	$5,506	$7,102	$1,123

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

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The following tables show the average investment and interest income recognized for impaired loans.

	For the Three Months Ended March 31, 2012	
	Average Recorded Investment(1)	Interest Income Recognized
Real Estate Construction		
Construction, residential	$ 1,514	$ ---
Construction, other	5,891	10
Consumer Real Estate		
Equity lines	997	---
Residential closed-end first liens	258	---
Residential closed-end junior liens	---	---
Commercial Real Estate		
Multifamily real estate	529	---
Commercial real estate, owner occupied	4,627	14
Commercial real estate, other	---	---
Commercial Non Real Estate		
Commercial and industrial	671	---
Public Sector and IDA		
Public sector and IDA	---	---
Consumer Non Real Estate		
Credit cards	---	---
Automobile	---	---
Other consumer	68	---
Total	$ 14,555	$ 24

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

	Average Investment and Interest Income of Impaired Loans For the Year Ended December 31, 2011	
	Average Recorded Investment(1)	Interest Income Recognized
Consumer Real Estate(2)		
Closed-end Consumer Real Estate	$ 450	$ 3
Commercial Real Estate(2)		
College Housing	281	7
Office & retail	292	---
Hotel	3,445	41
Medical Professionals	67	5
General Contractors	112	4
Other commercial real estate	1,139	24
Commercial & Industrial(2)		

Commercial & Industrial	553	---
Construction, Development and Land(2)		
Residential	2,143	49
Commercial	252	8
Total	$8,734	$ 141

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

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An analysis of past due and nonaccrual loans as of March 31, 2012 follows:

	30 – 89 Days Past Due	90 or More Days Past Due	90 Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction				
Construction, Residential	$---	$1,256	$---	$ 1,256
Construction, Other	---	---	---	---
Consumer Real Estate				
Equity Lines	200	---	---	---
Residential closed-end first liens	1,404	556	163	717
Residential closed-end junior liens	172	35	---	182
Commercial Real Estate				
Multifamily Real Estate	1,334	250	---	529
Commercial Real Estate, Owner Occupied	1,605	1,413	36	1,991
Commercial Real Estate, Other	---	---	---	---
Commercial Non Real Estate				
Commercial and Industrial	45	489	5	586
Public Sector and IDA				
Public Sector and IDA	---	---	---	---
Consumer Non Real Estate				
Credit Cards	3	1	1	---
Automobile	186	5	5	---
Other Consumer Loans	94	67	---	67
Total	$5,043	$4,072	$210	$ 5,328

December 31, 2011

	30 – 89 Days Past Due	90 or More Days Past Due	90 Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Consumer Real Estate				
Equity Lines	$---	$---	$---	$ ---
Closed-ended Consumer Real Estate	1,735	658	346	313
Consumer Construction	---	---	---	---
Consumer Non-Real Estate				
Credit Cards	26	8	8	---
Consumer General	270	38	38	---
Consumer Overdraft	---	---	---	---
Commercial Real Estate				
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
Commercial and Industrial				
Commercial and Industrial	31	26	26	139
Construction, Development and Land				
Residential	---	1,290	---	1,290
Commercial	252	---	---	---
Total	$4,300	$3,284	$481	$ 5,204

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 March 31, 2012 and 2011 and December 31. 2011.

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

March 31, 2012

	Pass	Special Mention	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 Family Residential	$12,763	$---	$---
Construction, Other	26,175	2,961	---
Consumer Real Estate			
Equity Lines	18,845	200	---
Closed-End First Liens	117,866	566	1,682
Closed-End, Junior Liens	6,813	5	279
Commercial Real Estate			
Multifamily Residential Real Estate	29,839	1,232	164
Commercial RE Owner-Occupied	167,227	---	1,510
Commercial RE Non Owner-Occupied	93,920	3,170	---
Commercial Non Real Estate			
C & I, Non Real Estate	39,182	16	152
Public Sector and IDA			
States & Political Subdivisions	15,263	---	---
Consumer Non Real Estate			
Credit Cards	6,319	---	---
Automobile	12,548	95	73
Other Consumer	12,669	9	34
Total	$559,429	$8,254	$3,894

December 31, 2011

	Pass	Special Mention	Classified (Excluding Impaired)
Consumer Real Estate			
Equity Lines	$17,971	$---	$14
Closed-ended Consumer Real Estate	87,882	595	1,332
Consumer Construction	2,050	---	---
Consumer Non-Real Estate			
Credit Cards	6,594	---	1
Consumer General	22,679	42	105
Consumer Overdraft	285	---	1
Commercial Real Estate			
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
Commercial and Industrial			
Commercial and Industrial	37,252	196	137
Construction, Development and Land			
Residential	15,732	---	---
Commercial	22,409	2,961	130
Total	$563,687	$7,945	$4,242

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

The Company modified loans that were classified troubled debt restructurings during the three months ended March 31, 2012. The following table present restructurings by class that occurred during the period.

Note: only classes with restructured loans are presented.

	Restructurings that occurred during the three months ended March 31, 2012			
	Number of Contracts	Pre-Modification Outstanding Principal Balance	Post-Modification Outstanding Principal Balance	Impairment Accrued
Consumer Real Estate				
Closed-end first liens	3	$ 305	$ 324	$47
Closed-end junior liens	1	143	147	109
Commercial Real Estate				
Commercial real estate, owner occupied	1	17	22	---
Total	5	$ 465	$ 493	$156

The modifications provided payment relief primarily by extending maturity dates without reducing interest rates or amounts owed. Restructured loans are designated impaired and measured for impairment. Of the consumer real estate loans summarized above, two were loans previously modified and reported as troubled debt restructurings in prior quarters. The Company granted additional modifications in the first quarter of 2012, increasing the balance by $10 from December 31, 2011. The loans restructured in the current period are secured by real estate and the impairment measurement is based upon the fair value (reduced by selling costs) of the underlying collateral. The impairment measurement resulted in $156 accrued to the allowance for loan losses.

The following table presents restructured loans that were modified between the dates of April 1, 2011 and March 31, 2012 and that experienced payment default during the three months ended March 31, 2012. The company defines default as one or more payments that occur more than 30 days past the due date.

	Number of Contracts	Principal Balance	Impairment Accrued
Consumer Real Estate			
Closed-end first liens	1	$17	$---
Commercial Real Estate			
Multifamily	1	250	---
Commercial Non Real Estate			
Commercial and industrial	1	58	---
Consumer Non Real Estate			
Other consumer	1	67	8
Total	4	$392	$8

Of the restructured loans that experienced a payment delay of 30 days or more during the period, $267 are secured by real estate. The remaining restructured loans that experienced payment default during the period are secured by collateral other than real estate. The impairment measurement is based upon the fair value of the underlying collateral and as such, was not significantly affected by the payment default. All of the above loans are in nonaccrual status.

Note 5: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type as of March 31, 2012 are as follows:

	March 31, 2012			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
Available for sale:				
U.S. Treasury	$2,009	$119	$---	$2,128
U.S. Government agencies	118,568	878	882	118,564
Mortgage-backed securities	6,054	528	---	6,582
States and political subdivisions	46,891	1,940	12	48,819
Corporate	18,216	405	183	18,438
Federal Home Loan Bank stock	1,596	---	---	1,596
Federal Reserve Bank stock	92	---	---	92
Other securities	2,292	7	172	2,127
Total	$195,718	$3,877	$1,249	$198,346

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type as of March 31, 2012 are as follows:

	March 31, 2012			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
Held to maturity:				
U.S. Government agencies	$14,997	$488	$121	$15,364
Mortgage-backed securities	851	91	---	942
States and political subdivisions	122,865	7,817	151	130,531
Corporate	654	18	---	672
Total	$139,367	$8,414	$272	$147,509

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

	March 31, 2012			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Temporarily impaired securities:				
U.S. Government agencies and corporations	$72,910	$1,003	$---	$---
States and political subdivisions	9,777	162	256	1
Corporate debt securities	5,816	183	---	---
Other	---	---	133	172
Total temporarily impaired securities	$88,503	$1,348	$389	$173

	December 31, 2011			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Temporarily impaired securities:				
U.S. Government agencies and corporations	$6,230	$20	$---	$---
States 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

The Company had 96 securities with a fair value of $88,892 which were temporarily impaired at March 31, 2012. The total unrealized loss on these securities was $1,521. Of the temporarily impaired total, two securities with a fair value of $389 and an unrealized loss of $173 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at March 31, 2012 for the reasons set out below.

U.S. Government agencies. The unrealized losses in this category of investments were caused by interest rate and market fluctuations. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of these investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

States and political subdivisions. This category's unrealized losses are primarily the result of interest rate and market fluctuations and also a certain few ratings downgrades brought about by the impact of the economic downturn on states and political subdivisions. The contractual terms of the investments do not permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does not intend to sell any of the investments and it is not likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

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

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

As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital and a percentage of qualifying assets. In addition, NBB is eligible to borrow from the FHLB with borrowings collateralized by qualifying assets, primarily residential mortgage loans and NBB's capital stock investment in the FHLB. Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at March 31, 2012, management did not consider there to be any impairment.

Management regularly monitors the credit quality of the investment portfolio. Changes in ratings are noted and follow-up research on the issuer is undertaken when warranted. Management intends to carefully follow any changes in bond quality. Refer to “Securities” in this report for additional information.

Note 6: 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 were 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. 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 were effective for interim and annual periods beginning after December 15, 2011 with prospective application. The Company has included the required disclosures in its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income." The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments were effective for fiscal years and interim periods within those years beginning after December 15, 2011. The amendments did not require transition disclosures. The Company has included the required disclosures in its consolidated 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 were effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. 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 December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." The amendments are being made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company has included the required disclosures in its consolidated financial statements.

Note 7: Defined Benefit Plan

Components of Net Periodic Benefit Cost:

	Pension Benefits Three Months ended March 31,	
	2012	2011
Service cost	$117	$109
Interest cost	185	176
Expected return on plan assets	(269)	(203)
Amortization of prior service cost	(25)	(25)
Recognized net actuarial loss	127	73
Net periodic benefit cost	$135	$130

2012 Plan Year Employer Contribution

Without considering the prefunding balance, NBI's minimum required contribution to the National Bankshares, Inc. Retirement Income Plan (the "Plan") is $733. Considering the prefunding balance, the 2012 minimum required contribution is $0. The Company elected to contribute $183 to the Plan in the quarter ended March 31, 2012.

Note 8: Fair Value Measurements

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

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

Level 1 –	Valuation is based on quoted prices in active markets for identical assets and liabilities.
Level 2 –	Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
Level 3 –	Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

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

Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis:

		Fair Value Measurements at March 31, 2012 Using		
Description	Balance as of March 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	$2,128	$---	$2,128	$ ---
U.S. Government agencies and corporations	118,564	---	118,564	---
States and political subdivisions	48,819	---	48,819	---
Mortgage-backed securities	6,582	---	6,582	---
Corporate debt securities	18,438	---	18,438	---
Other securities	2,127	---	2,127	---
Total securities available for sale	$196,658	$---	$196,658	$ ---

		Fair Value Measurements at December 31, 2011 Using		
Description	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 at March 31, 2012 or December 31, 2011. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that the Company will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement. Troubled debt restructurings are impaired loans. The measurement of loss associated with impaired loans may be based on either the observable market price of the loan, the present value of the expected cash flows or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, if an appraisal of the real estate property is over 12 months old or if the real estate market is considered by management to be experiencing volatility, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal using observable market data, if the collateral is deemed significant. If the collateral is not deemed significant, the value of business equipment is based on the net book value on the borrower's financial statements. Likewise, values for inventory and accounts receivables collateral are based on the borrower's financial statement balances or aging reports (Level 3). Estimated losses on impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at March 31, 2012 and at December 31, 2011.

			Carrying Value		
Date	Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
March 31, 2012	Impaired loans net of valuation allowance	$ 2,461	$ ---	$ ---	$ 2,461
December 31, 2011	Impaired loans net of valuation allowance	5,968	---	---	5,968

The following table summarizes the activity in Company's impaired loans that were valued using Level 3 inputs for the three months ended March 31, 2012.

	Carrying Value, December 31, 2011	Additions	Deletions due to Foreclosure	Change in Balance (1)	Impaired Loans Removed from Level 3 (2)	Carrying Value, March 31, 2012
Impaired loans						
Principal balance	$ 7,091	$ 726	$ (423)	$ (34)	$ (4,306)	$ 3,054
Impairment allocation	1,123	120	(322)	(87)	(241)	593
Net impaired loans	$ 5,968	$ 606	$ (101)	$ 53	$ (4,065)	$ 2,461

(1) The reported amounts represent changes in the balance due to principal payments by borrowers and reductions in impairment measurements as a result of current valuation procedures.
(2) The reported amount represents loans that were valued using Level 3 inputs as of December 31, 2011 that no longer have impairment allocations under Level 3 valuation.

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 the first quarter of 2012 resulted in changes to valuation method from collateral-based to the present value of cash flows for certain loans, and resulted in reduced allocations for certain loans. 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 and allocation for these loans.

Certain loans were removed from impaired Level 3 due to foreclosure. None of the foreclosures resulted in increases to the Company's other real estate owned, as the loans were either unsecured or secured by properties that were purchased by third parties at auction.

The following table presents information about Level 3 Fair Value Measurements for March 31, 2012:

	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	Discounted appraised value	Selling cost	5% - 25% (14%)
Impaired loans	Discounted appraised value	Discount for lack of marketability and age of appraisal	0% - 50% (9%)
Impaired loans	Present value of cash flows	Discount rate	6.0% - 7.5% (6.2%)

Other Real Estate Owned

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

The following table summarizes the Company's other real estate owned that was measured at fair value on a nonrecurring basis at March 31, 2012 and at December 31, 2011.

			Carrying Value		
Date	Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
March 31, 2012	Other real estate owned net of valuation allowance	$ 940	$ ---	$ ---	$ 940
December 31, 2011	Other real estate owned net of valuation allowance	1,489	---	---	1,489

The following table summarizes the activity in the Company's other real estate owned that were valued using Level 3 inputs for the three months ended March 31, 2012

	Carrying Value, December 31, 2011	Additions	Sale of Property	Increase to Valuation Allowance	Carrying Value, March 31, 2012
Other real estate owned	$1,489	$---	$(543)	$(6)	$940

The following table presents information about Level 3 Fair Value Measurements for March 31, 2012:

	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other Real Estate Owned	Discounted appraised value	Selling cost	5% - 10% (6%)
Other Real Estate Owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0% - 22.57% (8.87%)

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

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

The carrying amounts approximate fair value.

Securities

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

Loans Held for Sale

The fair value of loans held for sale is based on commitments on hand from investors or prevailing market prices.

Loans

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

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

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

Deposits

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Commitments to Extend Credit and Standby Letters of Credit

The only amounts recorded for commitments to extend credit, standby letters of credit and financial guarantees written are the deferred fees arising from these unrecognized financial instruments. These deferred fees are not deemed significant at March 31, 2012 and December 31, 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:

	March 31, 2012				
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total Estimated Fair Value
Financial assets:					
Cash and due from banks	$12,241	$12,241			$12,241

Interest-bearing deposits	101,301	101,301			101,301
Securities	337,713		345,855		345,855
Mortgage loans held for sale	1,371		1,371		1,371
Loans, net	576,501		570,495	2,461	572,956
Accrued interest receivable	6,175		6,175		6,175
BOLI	19,991		19,991		19,991
Financial liabilities:					
Deposits	$931,792		$926,706		$926,706
Accrued interest payable	191		191		191

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

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
$ in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the “Company”), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Please refer to the financial statements and other information included in this report as well as the 2011 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

Cautionary Statement Regarding Forward-Looking Statements

We make forward-looking statements in this Form 10-Q that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management’s views and assumptions as of the date of this report. The words “believes,” “expects,” “may,” “will,” “should,” “proje
“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,
• loss or retirement of key executives,
• adverse changes in the securities market, and
• applicable accounting principles, policies and guidelines.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained in this report. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report. This discussion and analysis should be read in conjunction with the description of our “Risk Factors” in Item 1A. of our 2011 Annual Report on 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. Nonperforming assets increased during 2009 and 2010 but decreased in 2011. 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 factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, the timing of events that would impact the transactions could change.

Allowance for Loan Losses

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

Probable losses are accrued through two calculations, individual evaluation of impaired loans and collective evaluation of the remainder of the portfolio. Impaired loans are larger non-homogeneous loans for which there is a probability that collection will not occur according to the loan terms, as well as loans whose terms have been modified in a troubled debt restructuring. Impaired loans with an estimated impairment loss are placed on nonaccrual status. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan's fair value. Fair value of an impaired loan is measured by one of three methods, the fair value (less cost to sell) of collateral, the present value of future cash flows, or observable market price. For loans that are not collateral dependent, the potential loss is accrued in the allowance. For collateral-dependent loans, the potential loss is charged-off against the allowance, instead of being accrued. Impaired loans with partial charge-offs are maintained as impaired until it becomes evident that the borrower can repay the remaining balance of the loan according to the terms.

Non-impaired loans are grouped by portfolio segment and loan class. Loans within a segment or class have similar risk characteristics. Each segment and class is evaluated for probable loss by applying quantitative and qualitative factors, including net charge-off trends, delinquency rates, concentration trends and economic trends. The Company accrues additional estimated loss for criticized loans within each class and for loans designated high risk. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with payments of interest-only required. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

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

The estimate of the allowance for March 31, 2012 considered market and portfolio conditions during the first quarter of 2012 as well as the elevated levels of delinquencies and net charge-offs in 2010 and 2011. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 to the financial statements and "Asset Quality," and "Provision and Allowance for Loan Losses."

Goodwill and Core Deposit Intangibles

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company's goodwill impairment analysis considers three valuation techniques appropriate to the measurement. The first technique uses the Company's market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to NBI; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to NBI. Each measure indicated that the Company's fair value exceeded its book value, validating that goodwill is not impaired.
Certain key judgments were used in the valuation measurement. Goodwill is held by the Company's bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company's assets are comprised of the subsidiary bank's equity, the Company's market capitalization was used to estimate NBB's capitalization. Other judgments include the assumption that the companies and transactions used as comparables for the second and third technique were appropriate to the estimate of the Company's fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.
Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company amortizes intangible assets arising from branch transactions over their useful life. Core deposit intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

Overview

National Bankshares, Inc. ("NBI") is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg ("NBB") and National Bankshares Financial Services, Inc. ("NBFS"). NBB, which does business as National Bank from twenty-five office locations, is a community bank. NBB is the source of nearly all of the Company's revenue. NBFS does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.
NBI common stock is listed on the NASDAQ Capital Market and is traded under the symbol "NKSH." 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 three months ended March 31, 2012 and the year ended December 31, 2011. The measures for March 31, 2012 are annualized, except for basic net earnings per share and fully diluted net earnings per share.

		March 31, 2012			December 31, 2011	
Return on average assets		1.67	%		1.71	%
Return on average equity		12.40	%		12.89	%
Basic net earnings per share	$	0.64		$	2.54	
Fully diluted net earnings per share	$	0.64		$	2.54	
Net interest margin (1)		4.36	%		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 annualized return on average assets declined slightly for the three months ended March 31, 2012 as compared to the year ended December 31, 2011, due primarily to growth in average assets. The annualized return on average equity declined 49 basis points for the same period, due to growth in average equity. Average equity tends to build in the months preceding the payment of dividends which have historically been paid semi-annually.

The annualized net interest margin was a healthy 4.36% at the end of the first quarter of 2012, though down 23 basis points from the 4.59% reported for the year ended December 31, 2011. The primary factor driving the decrease in the net interest margin was the declining yield on earning assets offset by a smaller decline in the cost to fund earning assets.
The annualized noninterest margin decreased 9 basis points from 2011 primarily because of a decrease in noninterest expense. Please refer to the discussion under noninterest expense for further information.

Growth

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

	March 31, 2012	December 31, 2011	Percent Change
Interest bearing deposits	$ 101,301	$ 98,355	3.00 %
Securities	337,713	318,913	5.90 %
Loans, net	576,501	580,402	(0.67)%
Deposits	931,792	919,333	1.36 %
Total assets	1,083,842	1,067,102	1.57 %

Net loans contracted slightly from December 31, 2011 to March 31, 2012, due to competitive, economic and market forces. The increase in deposits generated the increases in securities and interest-bearing deposit assets.

Asset Quality

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

	March 31, 2012	March 31, 2011	December 31, 2011
Nonperforming loans	$ 5,328	$ 7,653	$ 5,204
Accruing restructured loans	3,742	---	3,756
Loans past due 90 days or more, and still accruing	210	1,078	481
Other real estate owned	940	2,222	1,489
Allowance for loan losses to loans	1.38 %	1.40 %	1.37 %
Net charge-off ratio	0.46 %	0.15 %	0.43 %
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	1.07 %	1.67 %	1.13 %
Ratio of allowance for loan losses to nonperforming loans	151.33 %	107.74 %	155.03 %

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. The recent economic recession and slow recovery have contributed to levels of some asset quality measures that are higher than normal for the Company. Overall, the indicators remained at similar levels to those at December 31, 2011, except other real estate owned which declined substantially. When compared to March 31, 2011, the annualized net charge-off rate increased while most other asset quality indicators improved substantially. The Company's risk analysis determined an allowance for loan losses of $8,063 at March 31, 2012, remaining at a similar level to the $8,068 at December 31, 2011. The provision for the three months ended March 31, 2012 was $672, a decrease of $128 or 16% from the $800 from the same period in 2011. The ratio of the allowance for loan losses to loans increased slightly from December 31, 2011, but was two basis points below the level at March 31, 2011. The stability in most asset quality indicators consistent with year-end 2011 levels contributed to a comparable

degree of allowance for loan losses. The Company continues to monitor risk levels within the loan portfolio.
Other real estate owned declined $549 from December 31, 2011 and $1,282 from March 31, 2011, primarily due to the disposal of such real estate. As of March 31, 2012, total properties approximating $627 are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB's other real estate owned properties are regularly marketed and sold.

Net Interest Income

The net interest income analysis for the three months ended March 31, 2012 and 2011 follows:

March 31, 2012			March 31, 2011		
Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average