

NATIONAL BANKSHARES INC

Form 10-K

March 12, 2008

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Fiscal Year Ended December 31, 2007

**o 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)

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### Securities registered pursuant to Section 12(b) of the Act:

None

### Securities registered Pursuant to Section 12(g) of the Act:

Common Stock, Par Value \$1.25 per share

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

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

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

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governance) on June 30, 2007 (the last business day of the most recently completed second fiscal quarter) was approximately \$134,464,928. As of February 15, 2008, the registrant had 6,932,474 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**

National Bankshares, Inc. 2007 Annual Report to Stockholders

National Bankshares, Inc. Proxy Statement for the 2008 Annual Meeting of Stockholders

#### **Part of Form 10-K into which incorporated**

Part II

Part III

**NATIONAL BANKSHARES, INC. AND SUBSIDIARIES**

Form 10-Q

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## **Part I**

\$ in thousands, except per share data.

### **Item 1. Business**

#### **History and Business**

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

#### **The National Bank of Blacksburg**

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

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

At December 31, 2007, NBB had total assets of \$882,866 and total deposits of \$776,431. NBB's net income for 2007 was \$12,857, which produced a return on average assets of 1.49% and a return on average equity of 13.29%. 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 Bankers Investments, LLC to provide investments and with Bankers Insurance, LLC for insurance products. NBFS does not significantly contribute to NBI's net income.

#### **Operating Revenue**

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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, 2007, 2006 and 2005 is set out in the following table.

Period	Class of Service	Percentage of Total Revenues	
December 31, 2007	Interest and Fees on Loans	62.60	%
	Interest on Investments	21.46	%
December 31, 2006	Interest and Fees on Loans	61.51	%
	Interest on Investments	21.76	%
December 31, 2005	Interest and Fees on Loans	62.71	%
	Interest on Investments	21.96	%

### Market Area

NBB's market area in southwest Virginia is made up of the counties of Montgomery, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It also includes the independent cities of Radford and Galax, and the portions of Carroll and Grayson Counties that are adjacent to Galax. The bank also serves those portions of Mercer County and McDowell County, West Virginia that are contiguous with Tazewell County, Virginia. Although largely rural, the market area is home to two major universities, Virginia Tech and Radford

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University, and to three community colleges. Virginia Tech, located in Blacksburg, Virginia, is the area's largest employer and is the Commonwealth's largest university. A second state supported university, Radford University, is located nearby. Employment at the universities has been stable and is expected to remain so. In recent years Virginia Tech's Corporate Research Center has brought several high-tech companies to Montgomery County.

In addition to education, the market area has a diverse economic base, with manufacturing, agriculture, tourism, healthcare, retail and service industries all represented. Large manufacturing facilities in the region include Celanese Acetate, the largest employer in Giles County, and Volvo Heavy Trucks, the largest company in Pulaski County. Both of these firms have experienced layoffs within the past three years. Pulaski and Galax have been centers for furniture manufacturing. In recent years, this industry has been declining because of growing furniture imports, and Pulaski Furniture Company closed its Pulaski plant during 2007. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that has been improving over the past few years. Both Montgomery County and Bluefield in Tazewell County are regional retail centers and have facilities to provide basic health care for the region.

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

### Competition

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

### Organization and Employment

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

At December 31, 2007, NBI employed 17 full time employees, NBB had 222 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. A brief summary follows of certain laws, rules and regulations which affect NBI and NBB. Any changes in the laws and regulations governing banking and financial services could have an adverse effect on the business prospects of NBI and NBB.

**National Bankshares, Inc.**

NBI is a bank holding company 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



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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.

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

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

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

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

### **The National Bank of Blacksburg**

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

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add to overhead expense for NBB and other banks.

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

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

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

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

*Deposit Insurance.* NBB has deposits that are insured by the Federal Deposit Insurance Corporation (FDIC). FDIC maintains a Bank Insurance Fund (BIF) that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the BIF declines in relation to the total amount of insured deposits. After several years with no BIF assessment, NBB was required to pay the minimum BIF assessment in 2007. However, NBB had certain payment credits that offset the 2007 assessment increase.

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 OCC. The OCC guidelines provide that banks experiencing internal growth or making acquisitions are expected to maintain strong capital positions well above minimum levels, without reliance on intangible assets.

*Limits on Dividend Payments.* A significant portion of NBI's income is derived from dividends paid by NBB. As a national bank, NBB may not pay dividends from its capital, and it may not pay dividends if the bank would 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 payment were determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the bank's capital base could be deemed to be an unsafe and unsound banking practice.

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

### **Monetary Policy**

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

### **Other Legislative and Regulatory Concerns**

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

### **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

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Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission.

### **Item 1A. Risk Factors**

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

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

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

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

#### **If the subprime mortgage crisis spreads further and is not resolved, our business could be negatively affected.**

Although we have never engaged in subprime lending, the subprime crisis could impact us in several ways. If consumers are afraid to purchase real estate for an extended period, demand for loans for real estate development purposes will shrink and existing loans may become delinquent. In addition, the Company would see a drop in fees earned from the sale of mortgage loans in the secondary market. If there is a general devaluation in real estate, loan collateral values would decline. Finally, since the Company holds many municipal bonds in its investment portfolio, the failure of bond insurers resulting from their investment in subprime lending could negatively impact the value of those investments.

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

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

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

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

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

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

focus more attention on our market, we could lose customers and our business could suffer.

**Item 1B. Unresolved Staff Comments**

There are none.

**Item 2. Properties**

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

**Item 3. Legal Proceedings**

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

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

No matters were submitted to a vote of security holders during the fourth quarter ended December 31, 2007.

**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, 2007, there were 899 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 2007 and 2006, adjusted for the effects of a March 31, 2006 2-for-1 stock split.

## Common Stock Market Prices

	2007		2006		Dividends per share	
	High	Low	High	Low	2007	2006
First Quarter	\$ 24.49	23.40	\$ 25.15	23.01	---	---
Second Quarter	24.49	20.20	24.99	21.90	0.37	0.36
Third Quarter	20.49	18.84	23.24	22.01	---	---
Fourth Quarter	19.75	16.48	24.64	22.30	0.39	0.37

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

The following table provides information about our purchases during the fourth quarter of 2007 of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934.

Fiscal Period	Total Number of Shares Purchased	Average Price Paid per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)	Approximate Number of Shares That May Yet Be Purchased Under the Plans or Programs(2)
October 1 - 31	1,600	\$ 19.78	1,600	75,350
November 1 - 30	5,400	\$ 19.34	5,400	69,950
December 1 - 31	5,200	\$ 18.48	5,200	64,750

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

**Stock Performance Graph**

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Index and a peer group index comprised of southeastern independent community banks and bank holding companies for the five-year period commencing on December 31, 2002. These comparisons assume the investment of \$100 in National Bankshares, Inc. common stock and in each of the indices on December 31, 2002, and the reinvestment of dividends.



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	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
NATIONAL BANKSHARES, INC.	100	165	184	166	176	130
INDEPENDENT BANK INDEX	100	137	156	167	194	147
NASDAQ INDEX	100	150	163	166	183	198

The peer group Independent Bank Index is the compilation of the total return to stockholders over the past five years of the following group of 29 independent community banks located in the southeastern states of Alabama, Florida, Georgia, North Carolina, South Carolina, Tennessee, Virginia and West Virginia: Auburn National Bancshares, Inc., United Security Bancshares, Inc., TIB Financial Corp., Seacoast Banking Corp., Centerstate Banks of Florida, Inc., Fidelity Southern Corp., Southeastern Banking Corporation, Southwest Georgia Financial Corp., PAB Bankshares, Inc., Uwharrie Capital Corp., Four Oaks Fincorp, Inc., Bank of Granite Corp., Carolina Trust Bank, FNB Financial Services Corp., BNC Bancorp, CNB Corporation, Geer Bancshares, Peoples Bancorporation, Inc., Community First Inc., Wilson Bank Holding Company, First Pulaski National Corporation, National Bankshares, Inc., Monarch Financial Holdings, Inc., FNB Corporation, American National Bankshares, Inc., Central Virginia Bankshares, Inc., Virginia Financial Group, C&F Financial Corporation and First Century Bankshares, Inc.

**Item 6. Selected Financial Data****National Bankshares, Inc. and Subsidiaries****Selected Consolidated Financial Data**

\$ in thousands, except per share data.

Years ended December 31,

	2007		2006		2005		2004		2003	
<b>Selected Income Statement Data:</b>										
Interest income	\$	50,769		\$	47,901		\$	45,380		\$ 41,492
Interest expense		21,745			18,564			14,180		11,125
Net interest income		29,024			29,337			31,200		30,367
Provision for loan losses		423			49			567		1,189
Noninterest income		8,760			8,802			7,613		7,142
Noninterest expense		20,956			21,670			21,898		20,336
Income taxes		3,730			3,788			3,924		3,754
Net income		12,675			12,632			12,424		12,230
<b>Per Share Data:</b>										
Basic net income		1.82			1.80			1.77		1.74
Diluted net income		1.82			1.80			1.76		1.73
Cash dividends declared		0.76			0.73			0.71		0.64
Book value		15.07			13.86			13.10		12.38
<b>Selected Balance Sheet Data at End of Year:</b>										
Loans, net		518,435			495,486			487,162		472,199
Total securities		273,343			285,489			272,541		250,708
Total assets		887,647			868,203			841,498		796,154
Total deposits		776,339			764,692			745,649		705,932
Stockholders' equity		104,800			96,755			91,939		87,088
<b>Selected Balance Sheet Daily Averages:</b>										
Loans, net		505,070			488,624			487,130		438,761
Total securities		282,734			271,066			261,743		250,305
Total assets		867,061			840,080			819,341		753,730
Total deposits		758,657			741,071			724,015		665,627
Stockholders' equity		100,597			94,194			90,470		84,479
<b>Selected Ratios:</b>										
Return on average assets		1.46	%		1.50	%		1.52	%	1.62
Return on average equity		12.60	%		13.41	%		13.73	%	14.48
Dividend payout ratio		41.80	%		40.44	%		40.17	%	36.83
Average equity to average assets		11.60	%		11.21	%		11.04	%	11.21



**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation**

\$ in thousands, except per share data.

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

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

Per share data has been adjusted to reflect a 2-for-1 stock split effective March 31, 2006.

**Critical Accounting Policies**

**General**

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

**Allowance for Loan Losses**

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

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

**Core deposit intangibles**

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

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

**Overview**

National Bankshares, Inc. is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. The National Bank of Blacksburg, which does business as National Bank from twenty-six office locations, is a community bank. NBB is the source of nearly all of the Company's revenue. National Bankshares Financial Services, Inc. does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future. Until May 26, 2006, NBI operated a second wholly-owned bank subsidiary, Bank of Tazewell County. On that date it was merged with and into the National Bank of Blacksburg.

**Performance Summary**

The following table presents NBI's key performance ratios for the years ending December 31, 2007 and December 31, 2006:

	12/31/07		12/31/06	
Return on average assets	<b>1.46</b>	%	1.50	%
Return on average equity	<b>12.60</b>	%	13.41	%
Basic net earnings per share	<b>\$ 1.82</b>		\$ 1.80	
Fully diluted net earnings per share	<b>\$ 1.82</b>		\$ 1.80	
Net interest margin <sup>(1)</sup>	<b>3.98</b>	%	4.13	%
Noninterest margin <sup>(2)</sup>	<b>1.41</b>	%	1.54	%

- (1) Net Interest Margin – Year-to-date tax equivalent net interest income divided by year-to-date average earning assets.
- (2) Noninterest Margin – Noninterest income (excluding securities gain and losses) less noninterest expense (excluding the provision for bad debts and income taxes) divided by average year-to-date assets.

Basic net earnings per share grew by \$0.02 per share because net earnings were higher than in 2006 and the number of shares of stock outstanding was slightly lower because of the Company's stock repurchase program. Although return on average assets and average equity declined slightly when compared with last year, they remained competitive when compared to peers. Return on average assets declined because internally generated growth in total assets in 2007 increased at a faster rate than net earnings. Return on average equity was lower than in 2006 because the Company's equity, mostly from retained earnings, increased more rapidly than did the current year's net earnings. Reflecting the effects of 2007 Federal Reserve interest rate increases on NBI's funding costs, the net interest margin declined to 3.98% from 4.13% during 2006. The noninterest margin declined by 13 basis points.

**Growth**

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

For the period ending	
12/31/07	12/31/06

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Securities	\$ 273,343	\$ 285,489
Loans, net	518,435	495,486
Deposits	776,339	764,692
Total assets	887,647	868,203

Total assets at December 31, 2007 were \$887,647, an increase of \$19,444 or 2.2%. Net loans increased \$22,949 or 4.6%. Total deposits at period-end were \$776,339, an increase of \$11,647 or 1.5%. Growth in 2007 and 2006 was internally generated.

### Asset Quality

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

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	12/31/07		12/31/06	
Nonperforming loans	\$ 1,150		\$ ---	
Loans past due over 90 days	1,181		681	
Other real estate owned	263		390	
Allowance for loan losses to loans	1.00	%	1.03	%
Net charge-off ratio	.07	%	.07	%

Nonperforming loans at December 31, 2007, all of which were nonaccrual loans, were \$1,150, or 0.22% of loans net of unearned income. One loan of \$1,144 accounted for the majority of the nonperforming loans total. At December 31, 2006, there were no nonperforming loans. At year-end 2007, loans past due 90 days or more were \$1,181, an increase of \$500 over December 31, 2006. Potential problem loans, or loans about which management has serious doubts about the borrowers' ability to repay according to the terms of the loan, were \$1,500 at December 31, 2007. Additional information about nonaccrual and past due loans is provided in "Balance Sheet – Loans – Risk Elements"

The ratio of the allowance for loan losses to loans net of unearned income was 1.00% and 1.03% at December 31, 2007 and 2006, respectively. Management determined that it was prudent to make regular contributions to the provision for loan losses in 2007, because of the growth of the loan portfolio and because totals of nonperforming loans and loans past due 90 days or more increased from the historic lows of 2006. Loan growth slightly outpaced the amount of the provision, resulting in the three basis point decline in the ratio of the allowance for loan losses to net loans.

Although national economic trends were negative in the latter part of 2007, much of the Company's core market area has not been seriously affected by significantly higher foreclosure rates or other signs of a downturn. Management intends to make regular additions to the provision for loan losses in 2008 and to continue to closely monitor asset quality. Based upon its analysis of the allowance for loan losses and the stable net charge-off ratio, management believes that the ratio of the allowance for loan losses to net loans is prudent and appropriate.

### Net Interest Income

Net interest income for the period ended December 31, 2007 was \$29,024 a decrease of \$313, or 1.1%, when compared to the prior year. Net interest income at December 31, 2006 was \$29,337, a decrease of \$1,863, or 6%, from 2005. The net interest margin for 2007 was 3.98%, compared to 4.13% for 2006. The net decrease in the net interest margin is attributed to funding costs that rose at a faster rate than revenues from 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 interest-bearing liabilities. The Company has the ability to respond 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.

Interest rates have declined recently, and it is anticipated that rates will continue to fall in the future which will have a positive effect. Offsetting the effect of declining interest rates are higher rate securities, which can be called when interest rates fall, so that the issuer can re-finance its debt at a lower rate.

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 occasionally used. 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.

Overall, management expects gradual improvement in the net interest margin, provided that interest rates continue to trend downward or remain flat.





**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, 2007**