

ANNUAL REPORT 2006



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COMMITTED TO  
COMMUNITY BANKING

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National Bankshares



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## OUR MISSION

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NATIONAL BANKSHARES, INC. STRIVES TO BE AN exceptional community bank holding company dedicated to providing shareholder value by offering financial services to customers through subsidiary financial institutions and affiliated companies in an efficient, friendly, personalized, and cost-effective manner. We recognize that to do this, our financial institutions must retain the ability to make decisions locally and must actively participate in the communities they serve. We are committed to offering competitive and fair employment opportunities and to maintaining the highest standards in all aspects of our business.

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*United States Securities & Exchange Commission Form 10-K located in rear folder*

### A NOTE ON THIS YEAR'S REPORT

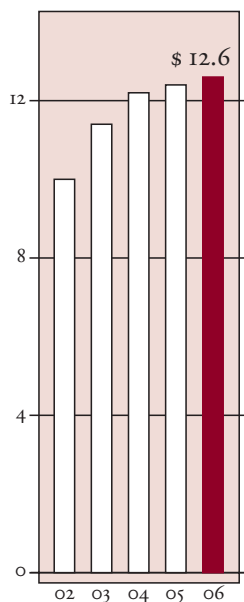
This year we've chosen the works of local artists to reflect our wonderful and unique surroundings in the mountains and valleys of Southwest Virginia. Cover: Martha Dillard, *Early in the Day II*. Inside cover (left): Joni Pienkowski, *Highland Over Ellett*.

## FINANCIAL HIGHLIGHTS

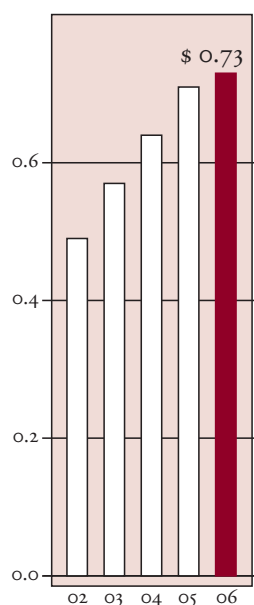
(\$ In thousands, except per share data)

	2006	2005	2004	2003	2002
Net income	\$ 12,632	12,424	12,230	11,442	10,014
Basic net income per share	1.80	1.77	1.74	1.63	1.43
Diluted net income per share	1.80	1.76	1.73	1.62	1.43
Cash dividends per share	0.73	0.71	0.64	0.57	0.49
Book value per share	13.86	13.10	12.38	11.47	10.41
Loans, net	495,486	487,162	472,199	401,428	404,247
Total securities	285,489	272,541	250,708	230,154	219,294
Total assets	868,203	841,498	796,154	708,560	684,935
Total deposits	764,692	745,649	705,932	625,378	608,271
Stockholders' equity	96,755	91,939	87,088	80,641	73,101

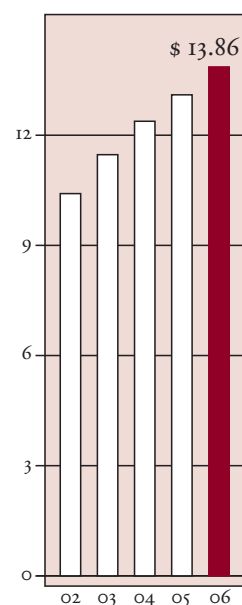
NET INCOME  
*dollars in millions*



CASH  
DIVIDENDS  
*dollars*



BOOK VALUE  
*dollars in millions*





Carol Hoge, untitled

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TO OUR SHAREHOLDERS

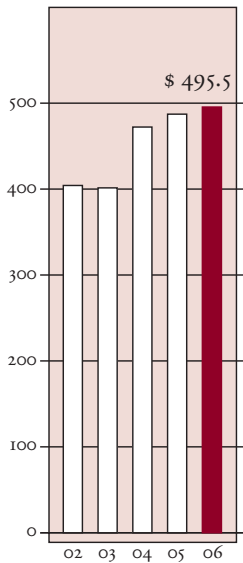
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*Though mergers and computer upgrades are important, stockholder value is driven by financial performance. I am glad to be able to report that National Bankshares, Inc. completed another successful year in 2006.*

**L**ast year when I wrote to you, we were anticipating the second quarter merger of National Bankshares, Inc.'s two subsidiary banks. With that challenge behind us, I am pleased to report that the slogan that we used to guide the merger, "We're better together", has proven to be true. We now offer our customers the convenience of full-service banking from 26 National Bank locations throughout Southwest Virginia. We have been able to consolidate several support functions, and we anticipate continuing this process. Finally, the merger gave us the opportunity to rejuvenate National Bank's brand image with new

signs, a logo that stresses the connection with National Bankshares and a fresh slogan that puts customers first, "Your Future. Your Bank." The merger was a significant undertaking that was accomplished with little impact on customers. However, all of our customers noticed the results of another major project that was completed in 2006, a computer upgrade that allows us to provide electronic check images instead of cancelled checks. This improvement makes check storage and retrieval much simpler for customers, and it allows the Bank to take advantage of the electronic exchange of checks that is the focus of the

NET LOANS  
dollars in millions

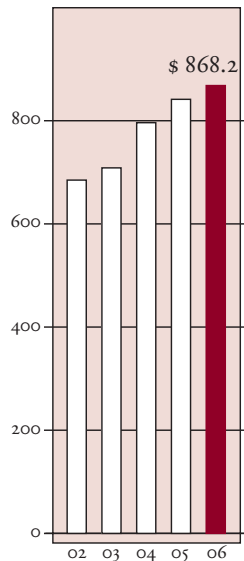


Federal Reserve Bank's Check 21 legislation.

Though mergers and computer upgrades are important, stockholder value is driven by financial performance. I am glad to be able to report that National Bankshares, Inc. completed another successful year in 2006. Your company posted record net income for the year of more than \$12.63 million, up from \$12.42 million in 2005. The pattern of interest rate

increases started by the Federal Reserve Bank in 2005 continued well into 2006. This compressed the net interest margin and kept the year-over-year increase in net income fairly small. However, in addition to higher earnings, there were several bright spots in the year's financial reports. Net loans were up at year-end, from \$487.16 million in 2005 to \$495.49 in 2006. Because loan quality was excellent, there was no need to fund the provision for loan losses above a minimal level. Total noninterest income, at \$8.80 million, showed a healthy 15.62% increase over 2005. We worked hard to contain controllable expenses despite the costs associated with the bank subsidiary merger, and total noninterest expense declined from nearly \$21.90 million in 2005 to \$21.67 million in 2006. National Bankshares, Inc. ended 2006 with total assets of just over \$868.20 million, up from nearly \$841.50 million in the prior year. As has been the tradition at National Bankshares, Inc.,

TOTAL ASSETS  
dollars in millions



we shared our record performance with you by increasing dividends paid to stockholders from \$0.71 per share in 2005 to \$0.73 in 2006.

For 2007 we are focusing on the basics. We believe that our employees are the best in the business, but we want them to be even better. So, this year we are emphasizing employee training and professional development. Because community banking relies on personal relationships, it is essential to equip National Bank and National Bankshares Financial Services employees with the skills necessary to provide consistently excellent customer service. We also intend to spend a good deal of time introducing our products and services to our neighbors in Southwest Virginia. We understand that they can choose from among numerous local, national and even Internet-based competitors. We want to explain to them the unique advantages of consolidating all of their banking, investments and insurance business with us. Since we are committed to community banking, this is a message that we can easily share.

In closing, I would like to thank you for your investment in National Bankshares, Inc. We appreciate your loyalty and support. I also want to acknowledge the hard work of our dedicated Directors and employees. It takes contributions from all of us – stockholders, Board members and employees – to produce success year after year at National Bankshares, Inc.



*Jim Rakes*

James G. Rakes  
Chairman of the Board  
President and Chief Executive Officer

## CONSOLIDATED BALANCE SHEETS

*\$ In thousands, except share data*

	December 31, 2006	December 31, 2005
<b>Assets</b>		
Cash and due from banks	\$ 15,283	20,115
Interest-bearing deposits	19,617	10,279
Securities available for sale, at fair value	169,735	162,833
Securities held to maturity (fair value approximates \$115,561 at December 31, 2006 and \$109,513 at December 31, 2005)	115,754	109,708
Mortgage loans held for sale	808	---
<b>Loans:</b>		
Real estate construction loans	33,840	27,116
Real estate mortgage loans	126,302	117,421
Commercial and industrial loans	215,244	206,389
Loans to individuals	126,316	142,598
Total loans	501,702	493,524
Less unearned income and deferred fees	(1,059)	(913)
Loans, net of unearned income and deferred fees	500,643	492,611
Less allowance for loan losses	(5,157)	(5,449)
Loans, net	495,486	487,162
Premises and equipment, net	12,702	12,808
Accrued interest receivable	5,682	5,145
Other real estate owned, net	390	376
Intangible assets and goodwill	15,976	17,113
Other assets	16,770	15,959
Total assets	\$ 868,203	841,498
<b>Liabilities and Stockholders' Equity</b>		
Noninterest-bearing demand deposits	\$ 101,167	112,445
Interest-bearing demand deposits	233,023	225,611
Savings deposits	47,988	54,505
Time deposits	382,514	353,088
Total deposits	764,692	745,649
Other borrowed funds	73	357
Accrued interest payable	863	725
Other liabilities	5,820	2,828
Total liabilities	771,448	749,559
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	---	---
Common stock of \$1.25 par value. Authorized 10,000,000 shares; issued and outstanding, 6,980,234 – 2006, and 7,019,874 in 2005	8,725	8,775
Retained earnings	91,123	84,610
Accumulated other comprehensive (loss), net	(3,093)	(1,446)
Total stockholders' equity	96,755	91,939
Total liabilities and stockholders' equity	\$ 868,203	841,498

**CONSOLIDATED STATEMENTS OF INCOME**

*\$ In thousands, except share per data*

	<b>Years ended December 31,</b>		
	<b>2006</b>	2005	2004
<b><i>Interest Income</i></b>			
Interest and fees on loans	\$ 34,879	33,234	29,812
Interest on federal funds sold	---	---	5
Interest on interest-bearing deposits	684	508	196
Interest on securities - taxable	7,462	6,501	6,184
Interest on securities - nontaxable	4,876	5,137	5,295
Total interest income	<u>47,901</u>	<u>45,380</u>	<u>41,492</u>
<b><i>Interest Expense</i></b>			
Interest on time deposits of \$100,000 or more	4,912	3,942	3,138
Interest on other deposits	13,626	10,215	7,973
Interest on borrowed funds	26	23	14
Total interest expense	<u>18,564</u>	<u>14,180</u>	<u>11,125</u>
Net interest income	29,337	31,200	30,367
Provision for loan losses	49	567	1,189
Net interest income after provision for loan losses	<u>29,288</u>	<u>30,633</u>	<u>29,178</u>
<b><i>Noninterest Income</i></b>			
Service charges on deposit accounts	3,361	3,099	3,003
Other service charges and fees	370	347	280
Credit card fees	2,396	2,179	1,839
Trust income	1,528	1,398	1,436
Other income	1,117	590	416
Realized securities gains, net	30	---	168
Total noninterest income	<u>8,802</u>	<u>7,613</u>	<u>7,142</u>
<b><i>Noninterest Expense</i></b>			
Salaries and employee benefits	11,466	11,265	10,498
Occupancy and furniture and fixtures	1,957	1,931	1,797
Data processing and ATM	1,234	1,455	1,302
Credit card processing	1,833	1,687	1,502
Intangible assets and goodwill amortization	1,137	1,117	967
Net costs of other real estate owned	19	275	201
Other operating expenses	4,024	4,168	4,069
Total noninterest expense	<u>21,670</u>	<u>21,898</u>	<u>20,336</u>
Income before income tax expense	16,420	16,348	15,984
Income tax expense	3,788	3,924	3,754
Net income	<u>\$ 12,632</u>	<u>12,424</u>	<u>12,230</u>
Basic net income per share	<u>\$ 1.80</u>	<u>1.77</u>	<u>1.74</u>
Fully diluted net income per share	<u>\$ 1.80</u>	<u>1.76</u>	<u>1.73</u>



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NATIONAL BANKSHARES, INC. BOARD OF DIRECTORS

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*From left:*

**Dr. Jeffrey R. Stewart**  
Educational Consultant

**Dr. James M. Shuler**  
Delegate, Virginia House of Delegates

**Dr. Mary G. Miller**  
President, Interactive Design and Development, Inc.

**Glenn P. Reynolds**  
President, Reynolds Architects, Inc.

**William A. Peery**  
President, Cargo Oil Co., Inc.

**Jack H. Harry**  
President, Harry Enterprises, Inc.

**Dr. Jack M. Lewis**  
President, New River Community College

**Lawrence J. Ball**  
Vice President and General Manager, Moog Components Group

**James G. Rakes**  
Chairman, President and Chief Executive Officer, National Bankshares, Inc.  
Chairman, President and Chief Executive Officer, National Bank  
Chairman, President and Treasurer, National Bankshares Financial Services, Inc.





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NATIONAL BANK BOARD OF DIRECTORS

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From left: **Charles E. Green, III**, Financial Planner, AXA Advisors, L.L.C.; **Dr. J. Lewis Webb, Jr.**, Dentist; **Michael E. Dye**, Pharmacist/Owner, New Graham Pharmacy; **James C. Thompson**, Chairman, Thompson & Litton; **F. Brad Denardo**, Executive Vice President/Chief Operating Officer, National Bank; **James S. Gillespie, Jr.**, President, Jim Sam Gillespie Farm; **Ellen G. Burnop**, Co-Owner, New River Office Supply; **James G. Rakes**, Chairman, President and Chief Executive Officer, National Bankshares, Inc., Chairman, President and Chief Executive Officer, National Bank, Chairman, President and Treasurer, National Bankshares Financial Services, Inc. Not pictured: **Dr. James M. Shuler**, Delegate, Virginia House of Delegates.

*National Bank Advisory Boards*

**Montgomery County:** Dan A. Dodson, W. Clinton Graves, Kathryn S. Oddo, James J. Owen, Arlene A. Saari, Ward W. Stevens, III, James C. Stewart, Marc A. Verniel, T. Cooper Via.

**Giles County:** Paul B. Collins, John H. Givens, Jr., Dr. Robert C. McCracken, Ross E. Martin, Kenneth L. Rakes, Scarlet B. Ratcliffe, H. M. Scanland, Jr., James E. Tyler.

**Galax:** Thomas L. McChesney, Dr. James A. Williams, Jr., David F. Wilson.

**Radford/Pulaski County:** William K. Cunningham, Jack D. Nunley, Laura B. Turk.

**Christiansburg:** Charles R. Beller, III, Gerard W. Higgins, Dr. Kenneth E. Jones, Dr. Peter J. McDonald, L. Scott Wade.

**Bluefield:** Don E. Neal, Michael E. Neal, Constance M. Saunders.

**Richlands:** Thurmon T. Hackworth, Dr. Marvin D. Harman, Peter M. Mulkey, John M. Warner.

**Interstate:** A. Susan Keen, Stephen A. Lester, II.

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## CORPORATE INFORMATION

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### ***National Bankshares, Inc. Executive Officers***

James G. Rakes  
Chairman, President and  
Chief Executive Officer

F. Brad Denardo  
Corporate Officer

J. Robert Buchanan  
Treasurer

Marilyn B. Buhyoff  
Secretary and Counsel

### ***Annual Meeting***

The Annual Meeting of Stockholders will be held on Tuesday, April 10, 2007 at 3:00 p.m. at Custom Catering Center, 902 Patrick Henry Drive, Blacksburg, Virginia.

### ***Corporate Stock***

National Bankshares, Inc. common stock trades on the Nasdaq Capital Market under the symbol "NKSH".

### ***Financial Information***

Investors and analysts seeking financial information about National Bankshares, Inc. should contact:

James G. Rakes  
Chairman, President and Chief Executive Officer  
(540) 951-6300 or (800) 552-4123  
jrakes@nbbank.com

*or*

J. Robert Buchanan  
Treasurer  
(276) 979-0341 or (800) 914-0516  
bbuchanan@nbbank.com

Written requests may be directed to: National Bankshares, Inc. P.O. Box 90002, Blacksburg, VA 24062-9002

### ***Stockholder Services and Stock Transfer Agent***

Stockholders seeking information about stock transfer requirements, lost certificates, dividends and other stockholder matters should contact:

Marilyn B. Buhyoff  
Secretary and Counsel  
(540) 951-6300 or (800) 552-4123  
mbuhyoff@nbbank.com

*or*

Registrar and Transfer Company  
10 Commerce Drive  
Crawford, NJ 07016-3572  
(800) 368-5948  
info@rtco.com

A copy of National Bankshares, Inc.'s annual report to the Securities and Exchange Commission on Form 10-K will be furnished without charge to any stockholder upon written request. The Form 10-K and other corporate publications are also available at [www.nationalbankshares.com](http://www.nationalbankshares.com).

### ***Corporate Office***

National Bankshares, Inc.  
101 Hubbard Street  
Blacksburg, Virginia 24060  
P.O. Box 90002  
Blacksburg, Virginia 24062-9002  
[www.nationalbankshares.com](http://www.nationalbankshares.com)  
(540) 951-6300 or (800) 552-4123



Jan Bos, *Hillside Barns: Catawba Valley*