NATIONAL BANKSHARES INC
Form 10-Q
May 12, 2014
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, 2014
[ ] 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	54-1375874
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

101 Hubbard Street

P. O. Box 90002

Blacksburg, VA	24062-9002
(Address of principal executive offices)	(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, 2014
Common Stock, $1.25 Par Value	6,947,974

(This report contains 52 pages)

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q

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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,** 2014	**December 31, 2013**
Assets		
Cash and due from banks	**$ 14,723**	$ 13,283
Interest-bearing deposits	**108,841**	97,376
Securities available for sale, at fair value	**190,401**	182,402
Securities held to maturity (fair value approximates $165,105 at March 31, 2014 and $159,337 at December 31, 2013)	**165,398**	163,983
Restricted stock, at cost	**1,089**	1,414
Mortgage loans held for sale	**---**	1,276
Loans:		
Loans, net of unearned income and deferred fees	**589,048**	595,690
Less allowance for loan losses	**(8,297)**	(8,227)
Loans, net	**580,751**	587,463
Premises and equipment, net	**9,428**	9,951
Accrued interest receivable	**5,893**	5,949
Other real estate owned, net	**4,901**	4,712
Intangible assets and goodwill	**8,029**	8,299
Bank-owned life insurance	**21,335**	21,181
Other assets	**12,321**	13,341
Total assets	**$ 1,123,110**	$ 1,110,630
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	**$ 145,963**	$ 142,645
Interest-bearing demand deposits	**503,596**	501,541
Savings deposits	**77,467**	74,141
Time deposits	**237,060**	241,709
Total deposits	**964,086**	960,036
Accrued interest payable	**78**	92
Other liabilities	**5,529**	4,610
Total liabilities	**969,693**	964,738
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 6,947,974 shares at March 31, 2014 and December 31, 2013	**8,685**	8,685
Retained earnings	**158,575**	154,171

Accumulated other comprehensive loss, net	**(13,843)**	(16,964)
Total stockholders' equity	**153,417**	145,892
Total liabilities and stockholders' equity	**$ 1,123,110**	$ 1,110,630

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, 2014 and 2013

(Unaudited)

$ in thousands, except per share data	**March 31, 2014**	**March 31, 2013**
Interest Income		
Interest and fees on loans	**$7,935**	$8,319
Interest on interest-bearing deposits	**65**	58
Interest on securities – taxable	**1,653**	1,512
Interest on securities – nontaxable	**1,500**	1,648
Total interest income	**11,153**	11,537
Interest Expense		
Interest on time deposits of $100 or more	**153**	268
Interest on other deposits	**1,162**	1,411
Total interest expense	**1,315**	1,679
Net interest income	**9,838**	9,858
Provision for loan losses	**103**	671
Net interest income after provision for loan losses	**9,735**	9,187
Noninterest Income		
Service charges on deposit accounts	**592**	588
Other service charges and fees	**65**	60
Credit card fees	**797**	740
Trust income	**293**	289
BOLI income	**175**	188
Other income	**277**	281
Realized securities gains, net (includes accumulated other comprehensive income reclassification adjustments for unrealized net gains (losses) in available-for-sale securities of $0 for the period ended March 31, 2014 and $9 for the period ended March 31, 2013)	**1**	9
Total noninterest income	**2,200**	2,155
Noninterest Expense		
Salaries and employee benefits	**2,999**	2,940
Occupancy and furniture and fixtures	**440**	432
Data processing and ATM	**363**	393
FDIC assessment	**147**	136
Credit card processing	**549**	552
Intangible assets amortization	**269**	271
Net costs of other real estate owned	**77**	75
Franchise taxes	**279**	258
Other operating expenses	**1,059**	907

Total noninterest expense	**6,182**	5,964
Income before income taxes	**5,753**	5,378
Income tax expense (includes income tax expense from reclassification items of $0 for the three months ended March 31, 2014 and $3 for the three months ended March 31, 2013)	**1,349**	1,162
Net Income	**$4,404**	$4,216
Basic net income per common share	**$0.63**	$0.61
Fully diluted net income per common share	**$0.63**	$0.60
Weighted average number of common shares outstanding – basic	**6,947,974**	6,947,974
Weighted average number of common shares outstanding – diluted	**6,963,865**	6,969,073
Dividends declared per common share	**$---**	$---

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Three Months Ended March 31, 2014 and 2013

(Unaudited)

$ in thousands	**March 31, 2014**	**March 31, 2013**
Net Income	**$4,404**	$4,216
Other Comprehensive Income (Loss), Net of Tax		
Unrealized holding gains (losses) on available for sale securities net of taxes of $1,681 and ($516) for the periods ended March 31, 2014 and 2013, respectively	**3,121**	(959)
Reclassification adjustment, net of taxes of $0 and ($3) for the periods ended March 31, 2014 and 2013, respectively	**---**	(6)
Other comprehensive income (loss), net of taxes of $1,681 and ($519) for the periods ended March 31, 2014 and 2013, respectively	**3,121**	(965)
Total Comprehensive Income	**$7,525**	$3,251

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

Three Months Ended March 31, 2014 and 2013

(Unaudited)

$ in thousands	**Common Stock**	**Retained Earnings**	**Accumulated Other Comprehensive Loss**	**Total**
Balances at December 31, 2012	$ 8,685	$ 144,162	$ (2,738)	$ 150,109
Net income	---	4,216	---	4,216
Other comprehensive loss, net of tax ($519)	---	---	(965)	(965)
Balances at March 31, 2013	$ 8,685	$ 148,378	$ (3,703)	$ 153,360
Balances at December 31, 2013	$ 8,685	$ 154,171	$ (16,964)	$ 145,892
Net income	---	4,404	---	4,404
Other comprehensive income, net of tax $1,681	---	---	3,121	3,121
Balances at March 31, 2014	**$ 8,685**	**$ 158,575**	**$ (13,843)**	**$ 153,417**

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Three Months Ended March 31, 2014 and 2013

(Unaudited)

$ in thousands	**March 31, 2014**	**March 31, 2013**
Cash Flows from Operating Activities		
Net income	**$4,404**	$4,216
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**103**	671
Depreciation of bank premises and equipment	**177**	188
Amortization of intangibles	**269**	271
Amortization of premiums and accretion of discounts, net	**42**	47
Losses on disposal of fixed assets	**94**	---
Gains on sales and calls of securities available for sale, net	**---**	(9)
Gains on calls of securities held to maturity, net	**(1)**	---
Losses and write-downs on other real estate owned, net	**16**	11
Increase in cash value of bank-owned life insurance	**(154)**	(167)
Net change in:		
Mortgage loans held for sale	**1,276**	2,483
Accrued interest receivable	**56**	369
Other assets	**(661)**	13
Accrued interest payable	**(14)**	7
Other liabilities	**919**	531
Net cash provided by operating activities	**6,526**	8,631
Cash Flows from Investing Activities		
Net change interest-bearing deposits	**(11,465)**	(10,579)
Proceeds from calls, principal payments, sales and maturities of securities available for sale	**2,173**	36,460
Proceeds from calls, principal payments and maturities of securities held to maturity	**3,929**	4,042
Purchases of securities available for sale	**(5,375)**	(39,040)
Purchases of securities held to maturity	**(5,381)**	(10,483)
Net change in restricted stock	**325**	(274)
Purchases of loan participations	**---**	(900)
Collections of loan participations	**1,348**	51
Loan originations and principal collections, net	**4,702**	16,952
Proceeds from disposal of other real estate owned	**196**	677
Recoveries on loans charged off	**158**	25
Proceeds from sale and purchases of bank premises and equipment, net	**254**	(24)
Net cash used in investing activities	**(9,136)**	(3,093)

Cash Flows from Financing Activities		
Net change in time deposits	**(4,649)**	(7,846)
Net change in other deposits	**8,699**	(1,801)
Net cash provided by (used in) financing activities	**4,050**	(9,647)
Net change in cash and due from banks	**1,440**	(4,109)
Cash and due from banks at beginning of period	**13,283**	14,783
Cash and due from banks at end of period	**$14,723**	$10,674
Supplemental Disclosures of Cash Flow Information		
Interest paid on deposits and borrowed funds	**$1,329**	$1,672
Income taxes paid	**1,472**	59
Supplemental Disclosure of Noncash Activities		
Loans charged against the allowance for loan losses	**$191**	$754
Loans transferred to other real estate owned	**401**	347
Unrealized net gains (losses) on securities available for sale	**4,802**	(1,484)

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

March 31, 2014

(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, 2014 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 2013 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 Per**	**Weighted Average Remaining Contractual**	**Aggregate Intrinsic Value**

		Share	Term	
Outstanding at January 1, 2014	46,000	$ 23.96		
Exercised	---	---		
Forfeited or expired	---	---		
Outstanding March 31, 2014	46,000	$ 23.96	1.11	$ 577
Exercisable at March 31, 2014	46,000	$ 23.96	1.11	$ 577

There were no shares exercised during the three months ended March 31, 2014 or March 31, 3013. As of March 31, 2014, there was no unrecognized compensation expense related to stock options.

Note 3: Loan Portfolio

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

	March 31, 2014	December 31, 2013
Real estate construction	**$42,307**	$45,925
Consumer real estate	**146,353**	145,499
Commercial real estate	**308,556**	311,266
Commercial non real estate	**32,016**	31,262
Public sector and IDA	**33,706**	34,220
Consumer non real estate	**27,008**	28,423
Gross loans	**589,946**	596,595
Less unearned income and deferred fees	**(898)**	(905)
Loans, net of unearned income and deferred fees	**$589,048**	$595,690

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 the 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 given risk ratings that indicate higher risk, such as "classified" or "other assets especially mentioned." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair market value. Impaired loans that are not troubled debt restructures and for which fair value measurement indicates an impairment loss are designated nonaccrual. A troubled debt restructure with an impairment loss may accrue interest if the loan shows a satisfactory repayment history for at least 6 months. Please refer to Note 1 of the Company's 2013 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, 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 a decline in estimates of cash

flow used in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent are charged down to fair value. Deficiencies indicated by impairment measurements for TDRs that are not collateral dependent may be accrued in the allowance for loan losses or charged off if deemed uncollectible.

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment. These characteristics include collateral type, repayment sources, and (if applicable) the borrower’s business model. The methodology for calculating reserves for collectively-evaluated loans is applied at the class level.

Portfolio Segments and Classes

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

Real Estate Construction	Consumer Non Real Estate
Construction, residential	Commercial and Industrial
Construction, other	
	Public Sector and IDA
Consumer Real Estate	Public sector and IDA
Equity lines	
Residential closed-end first liens	Commercial Non Real Estate
Residential closed-end junior liens	Credit cards
Investor-owned residential real estate	Automobile
	Other consumer loans
Commercial Real Estate	
Multifamily real estate	
Commercial real estate, owner-occupied	
Commercial real estate, other	

Historical Loss Rates

The Company's allowance methodology for collectively-evaluated loans applies historical loss rates by class to current class balances as part of the process of determining required reserves. Class loss rates are calculated as the net charge-offs for the class as a percentage of average class balance. The loss rate for the current quarter is averaged with that of prior periods to obtain the historical loss rate. Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance ("class loss rate"), and total net charge-offs for the class as a percentage of average classified loans in the class ("classified loss rate"). Classified loans are those with risk ratings of "substandard" or higher. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

Risk Factors

In addition to historical loss rates, risk factors pertinent to credit risk for each class are analyzed to estimate reserves for collectively-evaluated loans. Factors include changes in national and local economic and business conditions, the nature and volume of classes within the portfolio, loan quality, loan officers' experience, lending policies and the Company's loan review system.

The analysis of certain factors results in standard allocations to all segments and classes. These factors include loan officers' average years of experience, the risk from changes in lending policies, and the risk from changes in loan review. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include levels of past due loans, nonaccrual loans, current class balance as a percentage of total loans, and the

percentage of high risk loans (defined to be junior lien mortgages, high loan-to-value loans, and interest only loans) within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment.

Real estate construction loans are subject to general risks from changing commercial building and housing market trends and economic conditions that may impact demand for completed properties and the costs of completion. These risks are measured by market-area unemployment rates, bankruptcy rates, housing and commercial building market trends, and interest rates.

The credit quality of consumer real estate is subject to risks associated with the borrower's repayment ability and collateral value, measured generally by analyzing local unemployment and bankruptcy trends, local housing market trends, and interest rates.

The commercial real estate segment includes loans secured by multifamily residential real estate, commercial real estate occupied by the owner/borrower, and commercial real estate leased to non-owners. Loans in the commercial real estate segment are impacted by economic risks from changing commercial real estate markets, rental markets for multi-family housing and commercial buildings, business bankruptcy rates, local unemployment and interest rate trends that would impact the businesses housed by the commercial real estate.

Commercial non real estate loans are secured by collateral other than real estate, or are unsecured. Credit risk for commercial non real estate loans is subject to economic conditions, generally monitored by local business bankruptcy trends, and interest rates. Public sector and IDA loans are extended to municipalities and related entities. Credit risk is based upon the entity's ability to repay and interest rate trends.

Consumer non real estate includes credit cards, automobile and other consumer loans. Credit cards and certain other consumer loans are unsecured, while collateral is obtained for automobile loans and other consumer loans. Credit risk stems primarily from the borrower's ability to repay, measured by average unemployment, average personal bankruptcy rates and interest rates.

Factor allocations applied to each class are increased for loans rated special mention and classified. The Company allocates additional reserves for "high risk" 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, 2014							
	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, 2013	**$863**	**$ 1,697**	**$ 3,685**	**$ 989**	**$ 132**	**$ 576**	**$ 285**	**$8,227**
Charge-offs	**(2)**	**(54)**	**(52)**	**---**	**---**	**(83)**	**---**	**(191)**
Recoveries	**---**	**---**	**8**	**131**	**---**	**19**	**---**	**158**
Provision for loan losses	**(11)**	**171**	**53**	**(259)**	**70**	**17**	**62**	**103**
Balance, March 31, 2014	**$850**	**$ 1,814**	**$ 3,694**	**$ 861**	**$ 202**	**$ 529**	**$ 347**	**$8,297**

	Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2013							
	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, 2012	$1,070	$ 2,263	$ 3,442	$ 959	$ 142	$ 424	$ 49	$8,349
Charge-offs	(184)	(53)	(35)	(404)	---	(78)	---	(754)
Recoveries	---	---	---	16	---	9	---	25
Provision for loan losses	287	(364)	(118)	705	(32)	230	(37)	671
Balance, March 31, 2013	$1,173	$ 1,846	$ 3,289	$ 1,276	$ 110	$ 585	$ 12	$8,291

	Allowance for Loan Losses as of March 31, 2014							
	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	$---	**$ 9**	**$ 266**	**$ 5**	$ ---	$ ---	$ ---	**$280**
Collectively evaluated for impairment	**850**	**1,805**	**3,428**	**856**	**202**	**529**	**347**	**8,017**

Total	**$850**	**$ 1,814**	**$ 3,694**	**$ 861**	**$ 202**	**$ 529**	**$ 347**	**$8,297**

Allowance for Loan Losses as of December 31, 2013

	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	$---	$ 10	$ 610	$ 4	$ ---	$ ---	$ ---	$624
Collectively evaluated for impairment	863	1,687	3,075	985	132	576	285	7,603
Total	$863	$ 1,697	$ 3,685	$ 989	$ 132	$ 576	$ 285	$8,227

	Loans as of March 31, 2014							
	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	**$---**	**$ 730**	**$ 11,754**	**$ 94**	**$---**	**$ 24**	$ ---	**$ 12,602**
Collectively evaluated for impairment	**42,307**	**145,623**	**296,802**	**31,922**	**33,706**	**26,984**	---	**577,344**
Total loans	**$ 42,307**	**$ 146,353**	**$ 308,556**	**$ 32,016**	**$ 33,706**	**$ 27,008**	**$ ---**	**$ 589,946**

	Loans as of December 31, 2013							
	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	$---	$ 780	$ 12,079	$ 102	$---	$ 24	$ ---	$ 12,985
Collectively evaluated for impairment	45,925	144,719	299,187	31,160	34,220	28,399	---	583,610
Total	$ 45,925	$ 145,499	$ 311,266	$ 31,262	$ 34,220	$ 28,423	$ ---	$ 596,595

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

	Three Months Ended March 31, 2014	**2013**	**Year Ended December 31, 2013**
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees	**1.41 %**	1.44 %	1.38 %
Ratio of net charge-offs to average loans, net of unearned income and deferred fees[1]	**0.02 %**	0.50 %	0.28 %

[1] Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

	March 31,		December 31,
	2014	**2013**	**2013**
Nonperforming assets:			
Nonaccrual loans	**$5,071**	$10,734	$ 5,732
Restructured loans in nonaccrual	**1,007**	1,691	852
Total nonperforming loans	**6,078**	12,425	6,584
Other real estate owned, net	**4,901**	1,094	4,712
Total nonperforming assets	**$10,979**	$13,519	$ 11,296
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	**1.85 %**	2.35 %	1.88 %
Ratio of allowance for loan losses to nonperforming loans[1]	**136.51 %**	66.73 %	124.95 %

[1] The Company defines nonperforming loans as nonaccrual loans. Loans 90 days or more past due and still accruing and accruing restructured loans are excluded.

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

	March 31,		December 31,
	2014	**2013**	**2013**
Loans past due 90 days or more and still accruing	**$163**	$568	$ 190
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees	**0.03 %**	0.10 %	0.03 %
Accruing restructured loans	**$6,145**	$5,732	$ 6,191
Impaired loans:			
Impaired loans with no valuation allowance	**$10,139**	$16,263	$ 10,372
Impaired loans with a valuation allowance	**2,463**	995	2,613
Total impaired loans	**$12,602**	$17,258	$ 12,985
Valuation allowance	**(280)**	(273)	(624)
Impaired loans, net of allowance	**$12,322**	$16,985	$ 12,361
Average recorded investment in impaired loans[1]	**$13,075**	$17,935	$ 16,654
Interest income recognized on impaired loans, after designation as impaired	**$99**	$10	$ 267
Amount of income recognized on a cash basis	**$---**	$---	$ ---

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

Nonaccrual loans that meet the Company's balance threshold of $250 and TDRs are designated as impaired. No interest income was recognized on nonaccrual loans for the three months ended March 31, 2014 or March 31, 2013 or for the year ended December 31, 2013.

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, 2014				
	Principal Blance	**(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]					
Residential closed-end first liens	**$399**	**$ 401**	**$ 171**	**$ 230**	**$ 3**

Residential closed-end junior liens	**253**	**253**	**---**	**253**	**6**
Investor-owned residential real estate	**78**	**78**	**---**	**78**	**---**
Commercial Real Estate[(2)]					
Multifamily real estate	**3,271**	**3,268**	**3,268**	**---**	**---**
Commercial real estate, owner-occupied	**5,346**	**5,354**	**3,543**	**1,811**	**266**
Commercial real estate, other	**3,137**	**3,137**	**3,137**	**---**	**---**
Commercial Non Real Estate[(2)]					
Commercial and Industrial	**94**	**94**	**---**	**94**	**5**
Consumer Non Real Estate[(2)]					
Automobile	**24**	**24**	**24**	**---**	**---**
Total	**$12,602**	**$ 12,609**	**$ 10,143**	**$ 2,466**	**$ 280**

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

(2) Only classes with impaired loans are shown.

	Impaired Loans as of December 31, 2013				
	Principal Blance	(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]					
Residential closed-end first liens	$440	$ 442	$ 232	$ 210	$ 3
Residential closed-end junior liens	259	261	---	261	7
Investor-owned residential real estate	81	82	82	---	---
Commercial Real Estate[2]					
Multifamily real estate	3,278	3,274	3,274	---	---
Commercial real estate, owner occupied	5,643	5,645	3,864	1,781	610
Commercial real estate, other	3,158	3,158	3,158	---	---
Commercial Non Real Estate[2]					
Commercial and Industrial	102	103	1	102	4
Consumer Non Real Estate[2]					
Automobile	24	24	24	---	---
Total	$12,985	$ 12,989	$ 10,635	$ 2,354	$ 624

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

(2) Only classes with impaired loans are shown.

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

	For the Three Months Ended March 31, 2014	
	Average Recorded Investment[1]	Interest Income Recognized
Consumer Real Estate[2]		
Residential closed-end first liens	**$561**	**$ 4**
Residential closed-end junior liens	**257**	**5**

Investor-owned residential real estate	**79**	**1**
Commercial Real Estate[2]		
Multifamily real estate	**3,386**	**---**
Commercial real estate, owner occupied	**5,515**	**44**
Commercial real estate, other	**3,150**	**44**
Commercial Non Real Estate[2]		
Commercial and Industrial	**101**	**1**
Consumer Non Real Estate[2]		
Automobile	**26**	**---**
Total	**$ 13,075**	**$ 99**

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

(2) Only classes with impaired loans are shown.

	For the Year Ended December 31, 2013	
	Average Recorded Investment[1]	Interest Income Recognized
Real Estate Construction[2]		
Construction, residential	$40	$ ---
Construction, other	2,885	---
Commercial Real Estate[2]		
Residential closed-end first liens	364	3
Residential closed-end junior liens	280	9
Investor-owned residential real estate	131	6
Commercial Real Estate[2]		
Multifamily real estate	4,172	---
Commercial real estate, owner occupied	5,265	136
Commercial real estate, other	3,369	110
Commercial Non Real Estate[2]		
Commercial and Industrial	117	3
Consumer Non Real Estate[2]		
Automobile	31	---
Total	$16,654	$ 267

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

(2) Only classes with impaired loans are shown.

The Company reviews nonaccrual loans on an individual loan basis to determine whether future payments are reasonably assured. To satisfy this criteria, the Company's evaluation must determine that the underlying cause of the original delinquency or weakness that indicated nonaccrual status has been resolved, such as receipt of new guarantees, increased cash flows that cover the debt service or other resolution. Nonaccrual loans that demonstrate reasonable assurance of future payments and that have made at least six consecutive payments in accordance with repayment terms and timeframes may be returned to accrual status.

A restructured loan for which impairment measurement does not indicate a loss and that maintains current status for at least six months may be returned to accrual status.

An analysis of past due and nonaccrual loans as of March 31, 2014 follows.

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction				
Construction, residential	$163	$---	$ ---	$ ---
Construction, other	14	---	---	---
Consumer Real Estate				
Equity lines	---	---	---	---
Residential closed-end first liens	1,025	270	148	267
Residential closed-end junior liens	58	---	---	---
Investor-owned residential real estate	334	---	---	17
Commercial Real Estate				
Multifamily real estate	728	3,271	---	3,271
Commercial real estate, owner-occupied	128	1,477	---	2,378
Commercial real estate, other	---	---	---	---
Commercial Non Real Estate				
Commercial and Industrial	202	43	---	121
Public Sector and IDA				
Public sector and IDA	---	---	---	---
Consumer Non Real Estate				
Credit cards	2	3	3	---
Automobile	78	36	12	24
Other consumer loans	25	---	---	---
Total	$2,757	$5,100	$ 163	$ 6,078

An analysis of past due and nonaccrual loans follows.

December 31, 2013

	30 – 89 Days Past Due	90 or More Days Past Due	90 or More Days Past Due and Still Accruing	Nonaccruals (Including Impaired Nonaccruals)
Real Estate Construction				
Construction, residential	$45	$---	$ ---	$ ---
Construction, other	45	---	---	---
Consumer Real Estate				
Equity lines	---	---	---	---
Residential closed-end first liens	903	252	128	308
Residential closed-end junior liens	10	---	---	---
Investor-owned residential real estate	422	91	---	91
Commercial Real Estate				
Multifamily real estate	430	3,278	---	3,278
Commercial real estate, owner occupied	604	2,519	---	2,756
Commercial real estate, other	32	---	---	---
Commercial Non Real Estate				
Commercial and Industrial	196	43	---	128
Public Sector and IDA				
Public sector and IDA	---	---	---	---
Consumer Non Real Estate				
Credit cards	3	13	13	---
Automobile	217	26	2	23
Other consumer loans	49	46	47	---
Total	$2,956	$6,268	$ 190	$ 6,584

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, 2014 and 2013 and December 31, 2013.

The following displays collectively-evaluated loans by credit quality indicator.

March 31, 2014

	Pass	Special Mention	Classified (Excluding Impaired)
Real Estate Construction			
Construction, 1-4 family residential	**$14,910**	**$ 163**	**$ ---**
Construction, other	**27,191**	**29**	**14**
Consumer Real Estate			
Equity lines	**15,935**	**---**	**15**
Closed-end first liens	**80,765**	**658**	**1,343**
Closed-end junior liens	**5,279**	**55**	**2**
Investor-owned residential real estate	**41,089**	**103**	**379**
Commercial Real Estate			
Multifamily residential real estate	**67,175**	**---**	**728**
Commercial real estate owner-occupied	**131,259**	**2,175**	**754**
Commercial real estate, other	**90,473**	**1,201**	**3,037**
Commercial Non Real Estate			
Commercial and Industrial	**30,748**	**881**	**293**
Public Sector and IDA			
States and political subdivisions	**33,706**	**---**	**---**
Consumer Non Real Estate			
Credit cards	**5,141**	**---**	**---**
Automobile	**11,781**	**110**	**22**
Other consumer	**9,911**	**12**	**7**
Total	**$565,363**	**$ 5,387**	**$ 6,594**

The following displays collectively-evaluated loans by credit quality indicator.

December 31, 2013

	Pass	**Special Mention (Excluding Impaired)**	**Classified (Excluding Impaired)**
Real Estate Construction			
Construction, 1-4 family residential	$17,702	$ 163	$ 45
Construction, other	27,971	29	15
Consumer Real Estate			
Equity lines	16,146	16	---
Closed-end first liens	82,767	1,007	1,275
Closed-end junior liens	4,813	109	3
Investor-owned residential real estate	38,071	105	407
Commercial Real Estate			
Multifamily residential real estate	67,573	---	958
Commercial real estate owner-occupied	134,137	2,206	701
Commercial real estate, other	89,340	1,209	3,063
Commercial Non Real Estate			
Commercial and Industrial	29,987	878	295
Public Sector and IDA			
States and political subdivisions	24,220	---	---
Consumer Non Real Estate			
Credit cards	6,354	---	---
Automobile	11,428	253	34
Other consumer	10,253	17	60
Total	$570,762	$ 5,992	$ 6,856

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 modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to $7,152 at March 31, 2014, $7,043 at December 31, 2013, and $7,423 at March 31, 2013. The following tables present restructurings by class that occurred during three month period ended March 31, 2014, and the three month period ended March 31, 2013.

Note: Only classes with restructured loans are presented.

	Restructurings That Occurred During the Three Months Ended March 31, 2014		
	Number of Contracts	Pre-Modification Outstanding Principal Balance	Post-Modification Outstanding Principal Balance
Commercial Real Estate			
Commercial real estate, owner occupied	1	$ 184	$ 209
Total	1	$ 184	$ 209

During the three-month period ended March 31, 2014, the Company restructured one loan pursuant to bankruptcy court orders. The restructuring capitalized interest, reduced the interest rate and re-amortized payments. The fair value measurement of the restructured loan resulted in a specific allocation to the allowance for loan losses of $30.

	Restructurings That Occurred During the Three Months Ended March 31, 2013		
	Number of Contracts	Pre-Modification Outstanding	Post-Modification Outstanding

		Principal Balance	Principal Balance
Real Estate Construction			
Construction, other	1	$ 3,500	$ 3,500
Commercial Real Estate			
Commercial real estate, owner occupied	1	154	239
Total	2	$ 3,654	$ 3,739

The troubled debt restructurings during the first three months of 2013 provided payment relief to the borrowers without forgiveness of principal or accrued interest. The interest-only period on the real estate construction loan was extended beyond the contract date specified to begin amortization. The commercial real estate loan modification included an extended term, lower interest rate and new funds for debt consolidation to allow the borrower increased debt service ability. As troubled debt restructurings, the loans were individually evaluated under ASC 310. The impairment analysis was based upon the fair value of collateral for the construction loan and upon the present value of cash flows for the commercial real estate loan. The fair value measurements indicated fair values in excess of the loan balances and neither measurement resulted in a specific allocation.

The Company analyzed its TDR portfolio for loans that defaulted during the three-month periods ended March 31, 2014 and March 31, 2013, and that were modified within 12 months prior to default. The Company defines default as one or more payments that occur more than 90 days past the due date, or charge-offs or foreclosure after the date of restructuring. There were no restructured loans that defaulted and were modified within 12 months prior to default for the three-month period ended March 31, 2014.

The following table presents loans that defaulted and were restructured within 12 months prior to default for the three months ended March 31, 2013:

	Restructured Loans That Defaulted During the Three Months Ended March 31, 2013 That Were Modified Within 12 Months Prior to Default	
	Number of Contracts	**Principal Balance**
Consumer Real Estate		
Residential closed-end first liens	1	$ 101
Residential closed-end junior liens	1	88
Commercial Real Estate		
Commercial real estate owner-occupied	1	663
Commercial Non Real Estate		
Commercial and industrial	1	219
Total	4	$ 1,071

Restructured loans are individually evaluated for impairment. The fair value measurements for all of the restructured loans that defaulted during the three-month period ended March 31, 2013 were measured using the fair value of collateral and as such, were not significantly affected by the payment default. All were maintained on nonaccrual status as of March 31, 2013.

Note 5: Securities

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type are as follows.

	March 31, 2014			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
Available for Sale:				
U.S. Government agencies and corporations	**$173,798**	**$ 233**	**$ 17,696**	**$156,335**
States and political subdivisions	**21,634**	**813**	**39**	**22,408**
Mortgage-backed securities	**2,392**	**215**	**---**	**2,607**
Corporate debt securities	**8,802**	**83**	**312**	**8,573**
Other securities	**529**	**---**	**51**	**478**
Total	**$207,155**	**$ 1,344**	**$ 18,098**	**$190,401**

	December 31, 2013			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Fair Values
Available for Sale:				
U.S. Government agencies and corporations	$169,818	$ 199	$ 22,163	$147,854
States and political subdivisions	22,830	746	120	23,456
Mortgage-backed securities	2,627	213	---	2,840
Corporate debt securities	7,804	97	506	7,395
Other securities	879	---	22	857
Total securities available for sale	$203,958	$ 1,255	$ 22,811	$182,402

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type are as follows.

	March 31, 2014			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Held to Maturity:				
U.S. Government agencies and corporations	**$17,940**	**$ 298**	**$ 1,187**	**$17,051**
States and political subdivisions	**145,565**	**4,298**	**3,736**	**146,127**
Mortgage-backed securities	**484**	**52**	**---**	**536**
Corporate debt securities	**1,409**	**---**	**18**	**1,391**
Total	**$165,398**	**$ 4,648**	**$ 4,941**	**$165,105**

	December 31, 2013			
	Amortized Costs	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Values**
Held to Maturity:				
U.S. Government agencies and corporations	$13,973	$ 280	$ 1,448	$12,805
States and political subdivisions	149,490	2,971	6,502	145,959
Mortgage-backed securities	520	53	---	573
Total securities held to maturity	$163,983	$ 3,304	$ 7,950	$159,337

Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows.

	March 31, 2014			
	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	**$144,919**	**$ 15,556**	**$20,880**	**$ 3,327**
States and political subdivisions	**24,639**	**1,178**	**22,165**	**2,597**
Corporate debt securities	**8,094**	**330**	---	---
Other securities	**138**	**51**	---	---
Total	**$177,790**	**$ 17,115**	**$43,045**	**$ 5,924**

December 31, 2013

	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	$138,324	$ 20,400	$15,796	$ 3,211
States and political subdivisions	58,013	6,131	2,697	491
Corporate debt securities	5,511	506	---	---
Other securities	167	22	---	---
Total	$202,015	$ 27,059	$18,493	$ 3,702

The Company had 272 securities with a fair value of $220,835 which were temporarily impaired at March 31, 2014. The total unrealized loss on these securities was $23,039. Of the temporarily impaired total, 62 securities with a fair value of $43,045 and an unrealized loss of $5,924 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, 2014 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. The Company is monitoring bond market trends and developing strategies to address unrealized losses. At this time, the unrealized losses are not considered 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. 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. The Company's unrealized losses in corporate debt securities are related to 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 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 securities. The Company holds a small investment in community bank stock. The value of this investment has been negatively affected by market conditions. Because the Company does not intend to sell this investment 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, 2014, 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.

Note 6: Recent Accounting Pronouncements

In January 2014, the FASB issued ASU 2014-01, “Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force).” The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently assessing the impact that ASU 2014-01 will have on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, “Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).” The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, “Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity.” The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization’s operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

Note 7: Defined Benefit Plan

Components of Net Periodic Benefit Cost

	Pension Benefits	
	Three Months Ended March 31,	
	2014	**2013**
Service cost	**$131**	$149
Interest cost	**166**	154
Expected return on plan assets	**(278)**	(246)
Amortization of prior service cost	**(27)**	(25)
Recognized net actuarial loss	**65**	133
Net periodic benefit cost	**$57**	$165

2014 Plan Year Employer Contribution

Without considering the prefunding balance, the Company's minimum required contribution to the National Bankshares, Inc. Retirement Income Plan (the "Plan") is $396. Considering the prefunding balance, the 2014 minimum required contribution is $0. The Company elected to contribute $109 to the Plan during the three months ended March 31, 2014, for the plan year 2013.

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 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 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 assets and liabilities measured at fair value on a recurring basis.

		Fair Value Measurements at March 31, 2014 Using		
Description	**Balance as of March 31, 2014**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
U.S. Government agencies and corporations	**$156,335**	**$---**	**$ 156,335**	**$ ---**
States and political subdivisions	**22,408**	**---**	**22,408**	**---**
Mortgage-backed securities	**2,607**	**---**	**2,607**	**---**
Corporate debt securities	**8,573**	**---**	**8,573**	**---**
Other securities	**478**	**---**	**478**	**---**
Total securities available for sale	**$190,401**	**$---**	**$ 190,401**	**$ ---**

		Fair Value Measurements at December 31, 2013 Using		
Description	**Balance as of**	**Quoted Prices**	**Significant Other**	**Significant Unobservable**

	December 31, 2013	in Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Inputs (Level 3)
U.S. Government agencies and corporations	$ 147,854	$---	$ 147,854	$ ---
States and political subdivisions	23,456	---	23,456	---
Mortgage-backed securities	2,840	---	2,840	---
Corporate debt securities	7,395	---	7,395	---
Other securities	857	---	857	---
Total securities available for sale	$ 182,402	$---	$ 182,402	$ ---

Certain 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 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, 2014 or December 31, 2013. 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, 2014 and at December 31, 2013.

			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, 2014	Impaired loans net of valuation allowance	**$ 2,183**	**$---**	**$ ---**	**$ 2,183**
December 31, 2013	Impaired loans net of valuation allowance	1,989	---	---	1,989

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 following tables present information about Level 3 Fair Value Measurements for March 31, 2014 and December 31, 2013.

March 31, 2014	**Valuation Technique**	**Unobservable Input**	**Range (Weighted Average)**
Impaired loans	Discounted appraised value	Selling cost	0%[1] - 10.00% (0.67%)

[1] The collateral method of fair value measurement incorporates a discount for selling costs if collection of the loan is expected to come from sale of the collateral. Fair value measurement using the collateral method for a loan that is dependent on the operation, but not the sale, of collateral for collection is not discounted for selling costs.

Other Real Estate Owned

Other real estate owned are real estate assets acquired in full or partial satisfaction of a loan. At acquisition, other real estate owned assets are measured at fair value. If the assets are marketed for sale by an outside party, the acquisition-date fair value is discounted by selling costs; if the assets are marketed for sale by the Company, no reduction to fair value for selling costs is made. Subsequent to acquisition, the assets are measured at the lower of initial measurement or current fair value, discounted for selling costs as appropriate.

The fair value of an other real estate owned asset is determined by 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). If the appraisal is discounted either for age or because management considers the real estate market to be experiencing volatility, then the fair value is considered Level 3. Discounts for selling costs also result in measurement based on Level 3 inputs. Fair value adjustments are measured on a nonrecurring basis and are recorded in the period incurred as valuation allowances to other real estate owned, and expensed through noninterest expense.

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

			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, 2014	Other real estate owned net of valuation allowance	**$ 4,901**	**$ ---**	**$ ---**	**$ 4,901**
December 31, 2013	Other real estate owned net of valuation allowance	4,712	---	---	4,712

The following tables present information about Level 3 Fair Value Measurements for March 31, 2014 and December 31, 2013.

March 31, 2014	**Valuation Technique**	**Unobservable Input**	**Range**

			(Weighted Average)		
Other real estate owned	Discounted appraised value	Selling cost	0.00% [1]	- 10%	(5.50%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0.00%	-46.92%	(11.96%)

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

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

Cash and Due from Banks and Interest-Bearing Deposits

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 value for the loan portfolio is estimated on an account-level basis by discounting scheduled cash flows through the projected maturity for each loan. The calculation applies estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for loan classification, modified by an estimate of the effect of economic conditions on lending.

Impaired loans are individually evaluated for fair value. Fair value for the Company's impaired loans is estimated by using either discounted cash flows or the appraised value of collateral. Any amount of principal balance that exceeds fair value is accrued in the allowance for loan losses. Assumptions regarding credit risk, cash flows and discount rates are determined within management's judgment, using available market information and specific borrower information. Discount rates for cash flow analysis are based on the loan's interest rate, and cash flows are estimated based upon the loan's historical payment performance and the borrower's current financial condition. Appraisals may be discounted for age, reasonableness, and selling costs.

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.

Bank-Owned Life Insurance

Bank owned life insurance represents insurance policies on officers of the Company and certain officers who are no longer employed by the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the 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, 2014 and December 31, 2013, 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 follow.

	March 31, 2014				
	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	$14,723	$ 14,723	$ ---	$ ---	$ 14,723
Interest-bearing deposits	108,841	108,841	---	---	108,841
Securities	355,799	---	355,506	---	355,506
Restricted securities	1,089	---	1,089	---	1,089
Loans, net	580,751	---	---	568,229	568,229
Accrued interest receivable	5,893	5,893	---	---	5,893
Bank-owned life insurance	21,335	21,335	---	---	21,335
Financial Liabilities:					
Deposits	$964,086	$ 727,026	$ ---	$ 247,523	$ 974,549
Accrued interest payable	78	78	---	---	79

	December 31, 2013				
	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	$13,283	$13,283	$ ---	$ ---	$ 13,283
Interest-bearing deposits	97,376	97,376	---	---	97,376
Securities	346,385	---	341,739	---	341,739
Restricted securities	1,414	---	1,414	---	1,414
Mortgage loans held for sale	1,276	---	1,276	---	1,276
Loans, net	587,463	---	---	616,755	616,755
Accrued interest receivable	5,949	5,949	---	---	5,949
Bank-owned life insurance	21,181	21,181	---	---	21,181
Financial Liabilities:					
Deposits	$960,036	$718,327	$ ---	$ 247,753	$ 966,080
Accrued interest payable	92	92	---	---	92

Note 9: Components of Accumulated Other Comprehensive Loss

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive (Loss)
Balance at December 31, 2012	$ 2,047	$ (4,785)	$ (2,738)
Unrealized holding losses on available for sale securities net of tax of ($516)	(959)	---	(959)
Reclassification adjustment, net of tax of ($3)	(6)	---	(6)
Balance at March 31, 2013	$ 1,082	$ (4,785)	$ (3,703)
Balance at December 31, 2013	$ (14,011)	$ (2,953)	$ (16,964)
Unrealized holding gains on available for sale securities net of tax of $1,681	3,121	---	3,121
Reclassification adjustment, net of tax of $0	---	---	---
Balance at March 31, 2014	**$ (10,890)**	**$ (2,953)**	**$ (13,843)**

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 2013 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," "projects," "contemplates," "anticipates," "forecasts," "intends," or other similar words or terms are intended to identify forward-looking statements.

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

interest rates,

general economic conditions,

the legislative/regulatory climate,

monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 ("EESA") the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and other financial reform legislation,

unanticipated increases in the level of unemployment in the Company's trade area,

the quality or composition of the loan and/or investment portfolios,

demand for loan products,

deposit flows,

competition,

demand for financial services in the Company's trade area,

the real estate market in the Company's trade area,

the Company's technology initiatives,

threats from technology based frauds and scams,

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 2013 Annual Report on Form 10-K.

The effects of the recession continue 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 appeared to stabilize in 2012 and 2013 and showed signs of improving. 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 rates 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 funded by the provision for loan losses, reduced by charge-offs of loans and increased by recoveries of previously charged-off loans. The determination of the allowance is based on two accounting principles, Accounting

Standards Codification (“ASC”) Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss is reasonably estimable, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

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

Impaired loans

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

The Company bases collateral method fair valuation upon the “as-is” value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of $250 or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of $100 or greater and secured by one piece of collateral. Collateral-method impaired loans with principal balances below $100, or if secured by multiple pieces of collateral, below $250, are valued using an internal evaluation.

Appraisals and internal valuations provide an estimate of market value. Appraisals must conform to the Uniform Standards of Professional Appraisal Practice (“USPAP”) and are prepared by an independent third-party appraiser who is certified and licensed and who is approved by the Company. Appraisals incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value. Internal evaluations are prepared and reviewed by employees of the Company who are independent of the loan origination, operation, management and collection functions. Evaluations provide a property’s market value based on the property’s current physical condition and characteristics and the economic market conditions that affect the collateral’s market value. Evaluations incorporate multiple sources of data to arrive at a property’s market value, including physical inspection, tax values, independent third-party automated tools, comparable sales analysis and local market information.

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

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

Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment with at least six months of consecutive timely payment performance, unless the impairment measurement indicates a loss. Troubled debt restructurings with impairment losses remain in nonaccrual status.

Collectively-evaluated loans

Non-impaired loans and smaller homogeneous impaired loans that are not troubled debt restructurings and not part of a larger impaired relationship are grouped by portfolio segments that are made up of smaller loan classes. Loans within a segment or class have similar risk characteristics.

Probable loss is determined by applying historical net charge-off rates as well as additional percentages for trends and current levels of quantitative and qualitative factors. Loss rates are calculated for and applied to individual classes. Beginning with the first quarter of 2014, the Company began calculating the applicable loss rates by averaging loss rates over the most recent 8 quarters. Prior to 2014, the Company annualized the current year-to-date loss rate and averaged it with the loss rate of the previous year. The two methods yield similar results, and at the end of the year will yield the same average loss rate. The Company transitioned to using 8 quarters in order to provide ease of calculation on an ongoing basis. The look-back periods of 8 quarters beginning in 2014 and two years for periods ended December 31, 2013 and prior are applied consistently among all classes.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance (“class loss rate”), and total net charge-offs for the class as a percentage of average classified loans in the class (“classified loss rate”). Classified loans are those with risk ratings of “substandard” or higher. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

Trends and current levels of qualitative factors are evaluated and allocations are applied to each class. Qualitative factors include delinquency rates, loan quality and concentrations, loan officers’ experience, changes in lending policies and changes in the loan review process. Economic factors such as unemployment rates, bankruptcy rates and others are also evaluated, with standard allocations applied consistently to relevant classes.

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

Estimation of the allowance for loan losses

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

The estimate of the allowance for March 31, 2014 considered market and portfolio conditions during the first three months of 2014 as well as the levels of delinquencies and net charge-offs in 2013. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 4 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 most recent impairment test was performed in the fourth quarter of 2013. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. The Company opted not to perform the preliminary assessment. The Company’s goodwill impairment analysis considered three valuation techniques appropriate to the measurement. The first technique uses the Company’s market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to the Company; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to the Company. Each measure indicated that the Company’s fair value exceeded its book value, validating that goodwill is not impaired.

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

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

Overview

National Bankshares, Inc. (“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” or “the Bank”) 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.

Lending

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, small and mid-sized businesses, non-profits and local governments. Loan types include commercial and agricultural, commercial real estate, construction for commercial and residential properties, residential real estate, home equity and various consumer loan products. Of primary consideration in the Bank’s decision to extend credit is the repayment ability of the borrowers and (if secured) the collateral value in relation to the principal balance. Collateral value lowers risk and may be used as a secondary source of repayment. The credit decision is supported by documentation appropriate to the type of loan, including current financial information, income verification or cash flow analysis, tax returns, credit reports, collateral information, guarantor verification, title reports, appraisals (where appropriate), and other documents. A discussion of underwriting policies and procedures specific to the major loan products follows.

Commercial and agricultural loans primarily finance equipment acquisition, expansion, working capital, and other general business purposes. Because these loans have a higher degree of risk, the Bank generally obtains collateral such as inventories, accounts receivable or equipment, and personal guarantees from the borrowing entity's principal owners. The Bank's policy limits lending to 60% of the appraised value for inventory and equipment and up to 70% for accounts receivables less than 90 days old. Credit decisions are based upon an assessment of the financial capacity of the applicant, including the primary borrower's ability to repay within proposed terms, a risk assessment, financial strength of guarantors and adequacy of collateral. Credit agency reports of individual owners' credit history supplement the analysis.

Commercial mortgages and construction loans are offered to investors, developers and builders, primarily within the Bank's market area in southwest Virginia. These loans are secured by first mortgages on real estate. The loan amount is generally limited to 80% of the collateral value, and is individually determined based on the property type, quality, location and sponsorship. Commercial properties include retail centers, apartments, and industrial properties.

Underwriting decisions are based upon an analysis of the economic viability of the collateral and creditworthiness of the borrower. The Bank obtains appraisals from qualified certified independent appraisers to establish the value of collateral properties. The property's projected net cash flows compared to the debt service requirement (the "debt service coverage ratio" or "DSC" ratio) is required to be 110% or greater, and is computed after deduction for a vacancy factor and property expenses, as appropriate. Borrower cash flow may be supplemented by a personal guarantee from the principal(s) of the borrower, and guarantees from other parties. The Bank requires title insurance, fire, and extended coverage casualty insurance, and flood insurance, if appropriate, in order to protect the security interest in the underlying property. In addition, the Bank may employ stress testing techniques on higher balance loans to determine repayment ability in a changing rate environment before granting loan approval.

Construction loans are underwritten against projected cash flows from rental income, business and/or personal income from an owner-occupant or the sale of the property to an end-user. Associated risks may be mitigated by requiring fixed-price construction contracts, performance and payment bonding, controlled disbursements, and pre-sale contracts or pre-lease agreements.

The Bank offers a variety of first mortgage and junior lien loans secured by 1-4 family residences to individuals within our markets. Credit decisions are primarily based on loan-to-value ("LTV") ratios, debt-to-income ("DTI") ratios, liquidity, net worth, and DSC ratios. Income and financial information is obtained from personal tax returns, personal financial statements and employment documentation. A maximum LTV ratio of 80% is generally required, although higher levels are permitted with mortgage insurance. The debt-to-income ratio is limited to 40% of gross income.

Consumer real estate mortgages may have fixed interest rates for the entire term of the loan or variable interest rates subject to change yearly after the first, third, or fifth year. Variable rates are based on the weekly average yield of United States Treasury Securities and are underwritten at fully-indexed rates. We do not offer consumer real estate interest-only loans, sub-prime loans, or any variation on sub-prime lending including hybrid loans and payment option ARMs, or any product with negative amortization. Sub-prime loans involve extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. Payment option ARMs usually have adjustable rates, for which borrowers choose their monthly payment of either a full payment, interest only, or a minimum payment which may be lower than the payment required to reduce the balance of the loan in accordance with the originally underwritten amortization.

Home equity loans are secured primarily by second mortgages on residential property. The underwriting policy for home equity loans generally permits aggregate (the total of all liens secured by the collateral property) borrowing

availability up to 80% of the appraised value of the collateral. We offer variable rate home equity loans, with variable rate loans underwritten at fully-indexed rates. Decisions are primarily based on LTV ratios, DTI ratios and liquidity. We do not offer home equity loan products with reduced documentation.

Automobile loans include loans secured by new or used automobiles. Automobile loans are originated either on a direct basis or on an indirect basis through selected dealerships. We require borrowers to maintain collision insurance on automobiles securing consumer loans. Our procedures for underwriting automobile loans include an assessment of an applicant's overall financial capacity, including credit history and the ability to meet existing obligations and payments on the proposed loan. Although an applicant's creditworthiness is the primary consideration, the underwriting process also includes a comparison of the value of the collateral security to the proposed loan amount.

Performance Summary

The following table presents the Company's key performance ratios for the three months ended March 31, 2014 and the year ended December 31, 2013. The measures for March 31, 2014 are annualized, except for basic earnings per share and fully diluted earnings per share.

	March 31, 2014	**December 31, 2013**
Return on average assets	**1.61 %**	1.63 %
Return on average equity	**11.92 %**	11.90 %
Basic earnings per share	**$0.63**	$ 2.56
Fully diluted earnings per share	**$0.63**	$ 2.55
Net interest margin [1]	**4.12 %**	4.25 %
Noninterest margin [2]	**1.46 %**	1.43 %

(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 2 basis points for the three months ended March 31, 2014 as compared to the year ended December 31, 2013. The annualized return on average equity increased 2 basis points for the same period.

The annualized net interest margin was 4.12% for the three months ended March 31, 2014, down 13 basis points from the 4.25% reported for the year ended December 31, 2013. 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 increased 3 basis points from the year ended December 31, 2013. 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, 2014	December 31, 2013	Percent Change	
Interest-bearing deposits	**$108,841**	$97,376	11.77	%
Securities	**356,888**	347,799	2.61	%
Loans, net	**580,751**	587,463	(1.14)	%
Deposits	**964,086**	960,036	0.42	%
Total assets	**1,123,110**	1,110,630	1.12	%

Asset Quality

Key indicators of the Company's asset quality are presented in the following table.

	March 31, 2014		**March 31, 2013**		**December 31, 2013**	
Nonperforming loans	**$6,078**		$12,425		$ 6,584	
Loans past due 90 days or more, and still accruing	**163**		568		190	
Other real estate owned	**4,901**		1,094		4,712	
Allowance for loan losses to loans	**1.41**	**%**	1.44	%	1.38	%
Net charge-off ratio	**0.02**	**%**	0.50	%	0.28	%
Ratio of nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned	**1.85**	**%**	2.35	%	1.88	%
Ratio of allowance for loan losses to nonperforming loans	**136.51**	**%**	66.73	%	124.95	%

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. The Company's risk analysis for collectively-evaluated loans is based on historical charge-off rates, asset quality trends represented by past due and nonaccrual ratios, diversification of loans within the portfolio, the value of underlying collateral if secured, the risk of unsecured loans, and economic trends pertinent to the Company's loan portfolio.

The Company's risk analysis determined an allowance for loan losses of $8,297 at March 31, 2014, an increase from $8,227 at December 31, 2013 and $8,291 at March 31, 2013. The provision for the three months ended March 31, 2014 was $103, a decline from $671 for the same period in 2013. The ratio of allowance for loan losses to loans is 1.41% as of March 31 2014, compared with 1.38% December 31, 2013 and 1.44% at March 31, 2013.

Contributing to the decline in the provision for loan losses is an improved charge-off ratio for the three months ended March 31, 2014. The annualized net charge-off ratio is 0.02% for the first quarter of 2014, compared with 0.28% for the twelve-months ended December 31, 2013 and 0.50% for the three months ended March 31, 2013.

Asset quality indicators that improved from both December 31, 2013 and from March 31, 2013 included levels of nonperforming loans of $6,078 at March 31, 2014, compared with $6,584 at December 31, 2013 and $12,425 at March 31, 2013. The ratio of the allowance for loan losses to nonperforming loans improved to 136.51%, from 124.95% at December 31, 2013 and 66.73% at March 31, 2013. Loans past due 90 days or more and still accruing are $163, compared with $190 at December 31, 2013 and $568 at March 31, 2013. The ratio of nonperforming assets to loans and other real estate improved to 1.85% at March 31, 2014, compared with 1.88% at December 31, 2013 and 2.35% at March 31, 2013.

Economic factors were analyzed to determine their impact on the credit risk of the loan portfolio. Within the Company's market area, average unemployment, personal bankruptcy and business bankruptcy rates worsened, while the residential vacancy rate and inventory of residential real estate were slightly improved.

Other real estate owned increased $189 from December 31, 2013 and $3,807 from March 31, 2013. As of March 31, 2014, total properties approximating $885 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.

The recent economic recession and slow recovery have contributed to levels of asset quality measures that are higher than normal for the Company, however risk analyses show signs of improvement. When March 31, 2014 is compared to December 31, 2013, improvements in charge-off trends, nonperforming loans, accruing loans past due 90 days or more, residential vacancy rates and the inventory of residential real estate, were offset by slightly negative indications in average unemployment, personal bankruptcy and business bankruptcy rates. This resulted in a light increase to the allowance for loan losses from the level at December 31, 2013 and at March 31, 2014. The Company continues to monitor risk levels within the loan portfolio. Please refer to Note 4: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for further information on collectively-evaluated loans, individually-evaluated impaired loans and the unallocated portion of the allowance for loan losses.

Modifications and Troubled Debt Restructurings ("TDRs")

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

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

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

The Company began coding modification on the core processing system during the second quarter of 2013. The Company uses the coding to assist in identifying troubled debt restructurings. The majority of modifications completed since formal coding was implemented were granted for competitive reasons and did not constitute troubled debt restructurings. A description of modifications that did not result in troubled debt restructurings for the first quarter of 2014 follows:

Modifications To Borrowers Not Experiencing Financial Difficulty	**Number of Loans Modified**	**Total Amount Modified**
Rate reductions for competitive purposes	**11**	**$ 2,960**
Payment extensions for less than 3 months	**43**	**1,636**
Maturity date extensions of more than 1 month and up to 6 months	**58**	**19,837**
Maturity date extensions of more than 6 months and up to 12 months	**48**	**3,046**
Maturity date extensions of more than 12 months	**3**	**86**
Change in amortization term or method	**9**	**1,769**
Renewal of expired Home Equity Line of Credit loans to additional 10 years	**7**	**37**
Renewal of single-payment notes	**70**	**1,500**
Total modifications that do not constitute TDRs	**249**	**$ 30,871**

Modifications in which the borrower is experiencing financial difficulty and in which the Company makes a concession to the original contractual loan terms are designated troubled debt restructurings.

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

The Company recognizes that the current economy, elevated levels of unemployment and depressed real estate values have resulted in financial difficulties for some customers. The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure. All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans with an impairment loss or that do not demonstrate current payments for at least six months are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

The Company's TDRs were $7,152 at March 31, 2014, an increase from $7,043 at December 31, 2013. Accruing TDR loans amounted to $6,145 at March 31, 2014 and $6,191 at December 31, 2013. TDRs with a current payment history of at least 6 months may accrue interest.

TDR Status as of March 31, 2014

	Total TDR Loans	Accruing Current	Accruing 30-89 Days Past Due	Accruing 90+ Days Past Due	Nonaccrual
Real estate construction	**$---**	**$---**	**$ ---**	**$ ---**	**$ ---**
Consumer real estate	**730**	**570**	**---**	**---**	**160**
Commercial real estate	**6,371**	**5,524**	**---**	**---**	**847**
Commercial non real estate	**51**	**51**	**---**	**---**	**---**
Public sector and IDA	**---**	**---**	**---**	**---**	**---**
Consumer non real estate	**---**	**---**	**---**	**---**	**---**
Total TDR Loans	**$7,152**	**$6,145**	**$ ---**	**$ ---**	**$ 1,007**

TDR Status as of December 31, 2013

	Total TDR Loans	Accruing Current	Accruing 30-89 Days Past Due	Accruing 90+ Days Past Due	Nonaccrual
Real estate construction	$---	$---	$ ---	$ ---	$ ---
Consumer real estate	780	579	---	---	201
Commercial real estate	6,203	5,552	---	---	651
Commercial non real estate	60	60	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non real estate	---	---	---	---	---
Total TDR Loans	$7,043	$6,191	$ ---	$ ---	$ 852

Restructuring generally results in loans with either lower payments or an extended maturity beyond that originally required, and are expected to have a lower risk of loss due to nonperformance than loans classified as nonperforming. During the first quarter of 2014, the Company modified one loan totaling $209 in troubled debt restructurings, and during the first quarter of 2013, the Company modified 2 loans totaling $3,739. Please refer to Note 4 for information on troubled debt restructurings.

Net Interest Income

The net interest income analysis for the three months ended March 31, 2014 and 2013 follows:

	March 31, 2014				**March 31, 2013**			
	Average Balance	**Interest**	**Average Yield/ Rate**		**Average Balance**	**Interest**	**Average Yield/ Rate**	
Interest-earning assets:								
Loans, net (1)(2)(3)(4)	**$591,813**	**$8,071**	**5.53**	%	$583,912	$8,438	5.86	%
Taxable securities (5)	**205,857**	**1,653**	**3.26**	%	173,312	1,512	3.54	%
Nontaxable securities (1)(5)(6)	**162,413**	**2,325**	**5.81**	%	176,296	2,550	5.87	%
Interest-bearing deposits	**102,240**	**65**	**0.26**	%	99,216	58	0.24	%
Total interest-earning assets	**$1,062,323**	**$12,114**	**4.62**	%	$1,032,736	$12,558	4.93	%
Interest-bearing liabilities:								
Interest-bearing demand deposits	**$497,095**	**$911**	**0.74**	%	$448,817	$1,008	0.91	%
Savings deposits	**75,944**	**9**	**0.05**	%	70,647	8	0.05	%
Time deposits	**239,651**	**395**	**0.67**	%	275,857	663	0.97	%
Total interest-bearing liabilities	**$812,690**	**$1,315**	**0.66**	%	$795,321	$1,679	0.86	%
Net interest income and interest rate spread		**$10,799**	**3.96**	%		$10,879	4.08	%
Net yield on average interest-earning assets			**4.12**	%			4.27	%

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three-month periods presented.
(2) Included in interest income are loan fees of $144 and $286 for the three months ended March 31, 2014 and 2013, respectively.
(3) Nonaccrual loans are included in average balances for yield computations.
(4) Includes mortgage loans held for sale.
(5) Daily averages are shown at amortized cost.
(6) Includes restricted stock.

The net interest margin for the three months ended March 31, 2014 decreased 15 basis points from the three months ended March 31, 2013. The decrease in interest rate spread was driven by a decline in the yield on earning assets of 31 basis points offset by a decline in the cost of interest-bearing liabilities of 20 basis points. Both loans and securities experienced a decline in yields. The 33 basis point decline in the yield on loans stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The yield on taxable securities was 28 basis points lower for the three months ended March 31, 2014, when compared with the same period in 2013, while the yield on nontaxable securities declined 6 basis points over the same period. The market yield for securities of a comparable term has declined over the past year, causing matured and called bonds to be replaced with lower yielding investments. The decline in the cost of interest-bearing liabilities came mainly from a 30 basis point reduction in the cost of time deposits and a 17 basis point reduction in interest-bearing demand deposits when the three month periods ended March 31, 2014 and March 31, 2013 are compared.

The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment. In the recent past, historically low interest rates caused funding costs to decline at a faster pace than the yield on earning assets. The decline in deposit pricing has begun to slow while competitive and market forces continue to pressure the yield on earning assets. The Company's cost of funding is more sensitive to interest rate changes than is the yield on earning assets.

Provision and Allowance for Loan Losses

The provision for loan losses for the three month period ended March 31, 2014 was $103, compared with $671 for the three months of 2013. The provision for loan losses is the result of a detailed analysis performed to estimate an appropriate and adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at March 31, 2014 was 1.41%, which compares to 1.38% at December 31, 2013. The net charge-off ratio was 0.02% at March 31, 2014 and 0.28% at December 31, 2013. The change in the provision for loan losses was largely attributable to improvements in credit quality trends, lower net charge-offs, and higher recoveries of prior charge-offs during the first quarter of 2014. See “Asset Quality” for additional information.

Noninterest Income

	Three Months Ended			
	March 31, 2014	**March 31, 2013**	**Percent Change**	
Service charges on deposits	**$592**	$ 588	0.68	%
Other service charges and fees	**65**	60	8.33	%
Credit card fees	**797**	740	7.70	%
Trust fees	**293**	289	1.38	%
BOLI income	**175**	188	(6.91)	%
Other income	**277**	281	(1.42)	%
Realized securities gains	**1**	9	(88.89)	%

Service charges on deposit accounts for the three months ended March 31, 2014 increased $4 or 0.68% when compared with the same period in 2013.

Other service charges and fees includes charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Other service charges & fees for the three months ended March 31, 2014 increased $5 from the same period in 2013, due to minor and routine fluctuations.

Credit card fees for the three months of 2014 increased $57, or 7.70%, when compared with the same period last year. The increase was due to a higher volume of merchant transactions and credit card fees.

Income from trust fees increased 1.38% or $4 from the $289 earned in the same period of 2013. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income decreased $13 from March 31, 2013 to March 31, 2014.

Other income includes net gains from the sales of fixed assets, revenue from investment and insurance sales and other smaller miscellaneous components. Other income for the three months ended March 31, 2014 decreased $4 when compared with the three months ended March 31, 2013. These areas fluctuate with market conditions and because of competitive factors.

Net realized securities loss for the three months ended March 31, 2014 were $1, as compared with $9 for the same period in 2013. Net realized securities gains and losses are market driven and have resulted from calls and sales of securities.

Noninterest Expense

	Three Months Ended			
	March 31, 2014	**March 31, 2013**	**Percent Change**	
Salaries and employee benefits	**$2,999**	$2,940	2.01	%
Occupancy, furniture and fixtures	**440**	432	1.85	%
Data processing and ATM	**363**	393	(7.63)	%
FDIC assessment	**147**	136	8.09	%
Credit card processing	**549**	552	(0.54)	%
Intangibles amortization	**269**	271	(0.74)	%
Net costs of other real estate owned	**77**	75	2.67	%
Franchise taxes	**279**	258	8.14	%
Other operating expenses	**1,059**	907	16.76	%

Total noninterest expense increased $218 or 3.66% when the three months ended March 31, 2014 are compared to the same period of 2013. Most of the increase stemmed from an increase of $152 in other operating expense. The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations and other expenses. Contributing to the increase were higher telephone, charitable contributions and business development expenses, as well as a loss on the sale of fixed assets of $94.

FDIC assessment expense for the three months ended March 31, 2014 increased $11 or 8.09% over the same period for 2013. The calculation to determine the FDIC assessment uses assets as the assessment base.

Occupancy, furniture and fixtures expense increased 1.85%, from $432 for the three months ended March 31, 2013 to $440 as of March 31, 2014.

Salary and benefits expense was $2,999 for the three months ended March 31, 2014, similar to the $2,940 for the three months ended March 31, 2013.

Credit card processing expense decreased by 0.54% from the total for the three months ended March 31, 2013. This expense is driven by volume and other factors and is subject to a degree of variability.

Net costs of other real estate owned increased $2 from the three months ended March 31, 2013 to $77 for the three months ended March 31, 2014. This expense category includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market.

Data processing and ATM expense for the three months ended March 31, 2014 decreased $30 when compared with the expense for the three months ended March 31, 2013.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the past year, with minimal change in expense between the three month periods ended March 31, 2014 and March 31, 2013.

Bank franchise tax expense for the three months ended March 31, 2014 increased $21 or 8.14% over the same period in 2013. The tax is calculated based on equity.

Balance Sheet

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

	March 31, 2014	**December 31, 2013**	**Percent Change**
Assets			
Interest-bearing deposits	**$102,240**	$80,044	27.73 %
Securities available for sale and restricted stock	**186,666**	198,093	(5.77)%
Securities held to maturity	**162,782**	164,888	(1.28)%

Loans, net	**583,189**	577,746	0.94 %
Total assets	**1,108,867**	1,090,703	1.67 %
Liabilities and stockholders' equity			
Noninterest-bearing demand deposits	**$141,013**	$141,445	(0.31)%
Interest-bearing demand deposits	**497,095**	459,340	8.22 %
Savings deposits	**75,944**	72,783	4.34 %
Time deposits	**239,651**	259,914	(7.80)%
Stockholders' equity	**149,877**	149,491	0.26 %

Securities

Management regularly monitors the quality of the securities portfolio, and management closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 5 Securities for additional information.

Loans

	March 31, 2014	December 31, 2013	Percent Change
Real estate construction loans	**$42,307**	$45,925	(7.88)%
Consumer real estate loans	**146,353**	145,499	0.59 %
Commercial real estate loans	**308,556**	311,266	(0.87)%
Commercial non real estate loans	**32,016**	31,262	2.41 %
Public sector and IDA	**33,706**	34,220	(1.50)%
Consumer non real estate	**27,008**	28,423	(4.98)%
Less: unearned income	**(898)**	(905)	(0.77)%
Loans, net of unearned income	**$589,048**	$595,690	(1.12)%

The Company's loans net of unearned income decreased by $6,642 or 1.12%, from $595,690 at December 31, 2013 to $589,048 at March 31, 2014. Growth in commercial non real estate and consumer real estate loans was offset by declines in real estate construction loans of $3,618, public sector loans of $514 and consumer non real estate of $1,415 from December 31, 2013 to March 31, 2014.

The 4.98% decline in consumer non real estate loans continues a trend that has been evident over the past several years. The availability of low cost dealer auto loans and other products, such as home equity lines of credit, make traditional consumer installment loans less attractive to customers.

Commercial real estate loans declined $2,710 from December 31, 2013 while commercial non real estate loans increased by $754 or 2.41% from December 31, 2013. The changes are due to market, economic and competitive forces and are not the result of changes in lending policies.

The Company does not now, nor has it ever, offered certain types of higher-risk loans such as subprime loans, option ARM products, reverse mortgages or loans with initial teaser rates.

Deposits

	March 31, 2014	December 31, 2013	Percent Change
Noninterest-bearing demand deposits	**$145,963**	$ 142,645	2.33 %
Interest-bearing demand deposits	**503,596**	501,541	0.41 %
Saving deposits	**77,467**	74,141	4.49 %
Time deposits	**237,060**	241,709	(1.92)%
Total deposits	**$964,086**	$ 960,036	0.42 %

Total deposits increased $4,050, or 0.42% from $960,036 at December 31, 2013 to $964,086 at March 31, 2014. Increases in non-time deposits totaled $8,699, or 1.21%. These increases were offset by a decline time deposits of

$4,649, or 1.92%, when March 31, 2014 is compared with December 31, 2013. Historically low rates have caused a migration from time deposits to other types of deposits. As longer-term certificates of deposit mature, customers are unwilling to commit their funds for extended periods at low interest rates. Time deposits do not include any brokered deposits.

Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse sources of liquidity, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank ("FHLB") advances. At March 31, 2014, the bank did not have purchased deposits, discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

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

Regulatory capital levels determine the Company's ability to utilize purchased deposits and the Federal Reserve discount window for liquidity needs. At March 31, 2014, the Company is considered well capitalized and does not have any restrictions on purchased deposits or the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At March 31, 2014, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities. It also tests the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At March 31, 2014, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At March 31, 2014, the loan to deposit ratio was 61.10%, slightly below the Company's internal target. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered to account for projected funding needs.

Capital Resources

Total stockholders' equity at March 31, 2014 was $153,417, an increase of $7,525, or 5.16%, from the $145,892 at December 31, 2013. The Tier I and Tier II risk-based capital ratios at March 31, 2014 were 23.30% and 24.51%, respectively. Capital levels remain significantly above the regulatory minimum capital requirements of 4.0% for Tier I and 8.0% for Tier II capital.

Off-Balance Sheet Arrangements

In the normal course of business, NBB extends lines of credit and letters of credit to its customers. Depending on their needs, customers may draw upon lines of credit at any time in any amount up to a pre-approved limit. Standby letters of credit are issued for two purposes. Financial letters of credit guarantee payments to facilitate customer purchases. Performance letters of credit guarantee payment if the customer fails to complete a specific obligation.

Historically, the full approved amount of letters and lines of credit has not been drawn at any one time. The Company has developed plans to meet a sudden and substantial funding demand. These plans include accessing a line of credit with a correspondent bank, borrowing from the FHLB, selling available for sale investments or loans and raising additional deposits.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. Mortgages must meet strict underwriting and documentation requirements for the sale to be completed. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of March 31, 2014. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the three months ended March 31, 2014, except for normal seasonal fluctuations in the total of mortgage loan commitments.

Contractual Obligations

The Company had no capital lease or purchase obligations and no long-term debt at March 31, 2014. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material at the end of the three months of 2014 and have not changed materially from those which were disclosed in the Company's 2013 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2013 in the Company's 2013 Form 10-K.

Item 4. Controls and Procedures

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of March 31, 2014 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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

Part II

Other Information

Item 1. Legal Proceedings

There are no pending or threatened legal proceedings to which the Company or any of its subsidiaries is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

Item 1A. Risk Factors

Please refer to the "Risk Factors" previously disclosed in Item 1A of our 2013 Annual Report on Form 10-K and the factors discussed under "Cautionary Statement Regarding Forward-Looking Statements" in Part I. Item 2 of this Form 10-Q.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Subsequent Events

From March 31, 2014, the balance sheet date of this Form 10-Q, through the date of filing the Form 10-Q with the Securities and Exchange Commission, there have been no material subsequent events that 1) provide additional evidence about conditions that existed on the date of the balance sheet, or 2) provide evidence about conditions that did not exist at the date of the balance sheet, but arose after the balance sheet date.

Item 6. Exhibits

See Index of Exhibits.

Signatures

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

NATIONAL BANKSHARES, INC.

Date: May 12, 2014 /s/ James G. Rakes
James G. Rakes
Chairman, President and

Chief Executive Officer

(Principal Executive Officer)

Date: May 12, 2014 /s/ David K. Skeens
David K. Skeens
Treasurer and

Chief Financial Officer

(Principal Financial Officer)

(Principal Accounting Officer)

Index of Exhibits

Exhibit No.	- **Description**	**Page No. in Sequential System**
3(i)	Amended and Restated Articles of Incorporation of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	Amended By-laws of National Bankshares, Inc.	(incorporated herein by reference to Exhibit 3(ii) of the Annual Report on Form 10K for fiscal year ended December 31, 2007)
4(i)	Specimen copy of certificate for National Bankshares, Inc. common stock	(incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)
*10(iii)(A)	National Bankshares, Inc. 1999 Stock Option Plan	(incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999)
*10(iii)(A)	Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(iii)(A)	Executive Employment Agreement dated December 17, 2008, between National Bankshares, Inc. and F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(iii)(A)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)
*10(iii)(A)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on February 8, 2006)
*10(iii)(A)	Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(iii)(A)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)
*10(iii)(A)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on December 19, 2007)
*10(iii)(A)	First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(viii)(A)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on June 12, 2008)

*10(viii)(A)	Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(iii)(A)	Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(viii)(A)	Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo	(incorporated herein by reference to Exhibit 10(iii)(A) of the Annual Report on Form 10K for the fiscal year ended December 31, 2008)
*10(iii)(A)	Third Amendment, dated January 20, 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
*10(iii)(A)	Salary Continuation Agreement dated January 20, 2012 between The National Bank of Blacksburg and Bryson J. Hunter	(incorporated herein by reference to Exhibit 10(iii)(A) of the Form 8K filed on January 25, 2012)
31(i)	Section 906 Certification of Chief Executive Officer	(included herewith)
31(ii)	Section 906 Certification of Chief Financial Officer	(included herewith)
32(i)	18 U.S.C. Section 1350 Certification of Chief Executive Officer	(included herewith)
32(ii)	18 U.S.C. Section 1350 Certification of Chief Financial Officer	(included herewith)
101	Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2014 is formatted in XBRL interactive data files: (i) Consolidated Statements of Income for the three months ended March 31, 2014, and 2013; (ii) Consolidated Balance Sheets at March 31, 2014 and December 31, 2013; (iii) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2014 and 2013; (iv) Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and 2013; and (v) Notes to Financial Statements	

* Indicates a management contract or compensatory plan.