

NATIONAL BANKSHARES INC
Form 10-K
March 12, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2013

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 of incorporation) (I.R.S. Employer Identification No.)
101 Hubbard Street

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered Pursuant to Section 12(g) of the Act: Common Stock, Par Value \$1.25 per share

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

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

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governance) on June 30, 2013 (the last business day of the most recently completed second fiscal quarter) was approximately \$236,152,099. As of February 20, 2014, the registrant had 6,947,974 shares of voting common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference into the Part of the Form 10-K indicated.

Document	Part of Form 10-K into which incorporated
National Bankshares, Inc. 2013 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2014 Annual Meeting of Stockholders	Part III

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-K

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Part I

\$ in thousands, except per share data

Item 1. Business

History and Business

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

The National Bank of Blacksburg

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

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, businesses, non-profits and local governments from its headquarters in Blacksburg, Virginia and its twenty-four branch offices throughout southwest Virginia. NBB has telephone and internet banking and it operates twenty-two automated teller machines in its service area.

The Bank focuses lending on small and mid-sized businesses and individuals. 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. Each loan category requires underwriting and documentation suited to unique characteristics and inherent risks.

The Bank’s loan policy is updated and approved by the Board of Directors annually, and disseminated throughout the Bank to ensure consistent lending practices. The policy communicates the Company’s risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy, documentation standards, requirements for collateral and loan-to-value limits, debt coverage and overall credit-worthiness, and guarantor support.

Of primary consideration 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 must be 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 Loans. 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 receivables 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 Real Estate Loans. 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 are predominantly non-residential in nature, and 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. We require title insurance, fire, and extended coverage casualty insurance, and flood insurance, if appropriate, in order to protect our 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.

Consumer Real Estate Loans. The Bank offers a variety of first mortgage and junior lien loans secured by primary residences to individuals within our markets. Credit decisions are primarily based on loan-to-value (“LTV”) ratios, debt-to-income (“DTI”) ratios, liquidity, and net worth. 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 43% 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 interest-only loans, sub-prime loans, or any variation on subprime 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 they 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, liquidity, and credit scores. We do not offer home equity loan products with reduced documentation.

Automobile loans include loans and leases secured by new or used automobiles. We originate automobile loans 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.

Other Products and Services. Deposit products offered by the Bank include interest-bearing and non-interest bearing demand deposit accounts, money market deposit accounts, savings accounts, certificates of deposit and individual retirement accounts. Deposit accounts are offered to both individuals and commercial businesses. Merchant credit card services and business and consumer debit and credit cards are available. NBB offers other miscellaneous services normally provided by commercial banks, such as letters of credit, night depository, safe deposit boxes, travelers checks, utility payment services and automatic funds transfer. NBB conducts a general trust business that has wealth management, and trust and estate services for individual and business customers.

At December 31, 2013, NBB had total assets of \$1,107,992 and total deposits of \$960,219. NBB’s net income for 2013 was \$18,192, which produced a return on average assets of 1.67% and a return on average equity of 12.36%. Refer to Note 12 of the Notes to Consolidated Financial Statements for NBB’s risk-based capital ratios.

National Bankshares Financial Services, Inc.

In 2001, National Bankshares Financial Services, Inc. was formed in Virginia as a wholly-owned subsidiary of NBI. NBFS offers non-deposit investment products and insurance products for sale to the public. NBFS works cooperatively with Infinex Investments, Inc. to provide investments and with Bankers Insurance, LLC for insurance products. NBFS does not significantly contribute to NBI's net income.

Operating Revenue

The percentage of total operating revenue attributable to each class of similar service that contributed 15% or more of the Company's total operating revenue for the years ended December 31, 2013, 2012 and 2011 is set out in the following table.

Period	Class of Service	Percentage of Total Revenues	
December 31, 2013	Interest and Fees on Loans	59.71	%
	Interest on Investments	23.83	%
December 31, 2012	Interest and Fees on Loans	61.50	%
	Interest on Investments	22.75	%
December 31, 2011	Interest and Fees on Loans	62.49	%
	Interest on Investments	22.72	%

Market Area

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

In addition to education, the market area has a diverse economic base, with manufacturing, agriculture, tourism, healthcare, retail and service industries all represented. Large manufacturing facilities in the region include Celanese Acetate, the largest employer in Giles County, and Volvo Heavy Trucks, the largest company in Pulaski County. Both of these firms have experienced cycles of hiring and layoffs within the past several years. Pulaski and Galax have in the past been centers for furniture manufacturing. However, this industry has been declining because of growing furniture imports and the loss of demand. Several furniture companies have gone out of business in the recent past. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that was negatively affected by the economic decline. Montgomery County, Bluefield in Tazewell County and Abingdon in Washington County are regional retail centers and have facilities to provide basic health care for the region.

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

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

Competition

The banking and financial services industry in NBI's market area is highly competitive. The competitive business environment is a result of changes in regulation, changes in technology and product delivery systems and competition from other financial institutions as well as non-traditional financial services. NBB competes for loans and deposits with other commercial banks, credit unions, securities and brokerage companies, mortgage companies, insurance companies, retailers, automobile companies and other nonbank financial service providers. Many of these competitors

are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than NBB. In order to compete, NBB relies upon a deep knowledge of its markets, a service-based business philosophy, personal relationships with customers, specialized services tailored to meet customers' needs and the convenience of office locations. In addition, the bank is generally competitive with other financial institutions in its market area with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts.

Organization and Employment

NBI, NBB and NBFS are organized in a holding company/subsidiary structure. Functions that serve both subsidiaries, including audit, compliance, loan review and human resources, are at the holding company level, and fees are charged to the respective subsidiary for those services.

At December 31, 2013, NBI employed 20 full time employees, NBB had 202.5 full time equivalent employees and NBFS had 3 full time employees.

Regulation, Supervision and Government Policy

NBI and NBB are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like NBI and NBB are at a disadvantage to other competitors who are not as highly regulated, and NBI and NBB's costs of doing business are accordingly higher. Legislative efforts to prevent a repeat of the 2008 financial crisis culminated in the Dodd-Frank Wall Street Reform Act of 2010. This legislation, together with existing and planned regulations, has dramatically increased the regulatory burden on commercial banks. The burden falls disproportionately on community banks like NBB, which must devote a higher proportion of their human and other resources to compliance than do their larger competitors. The financial crisis has also heightened the examination focus by banking regulators, particularly on real estate related assets and commercial loans. In the current environment, the potential for additional laws and regulations that will impact the Company, as well as heightened examination standards with regard to asset quality, cannot be ruled out. The following is a brief summary of certain laws, rules and regulations that affect NBI and NBB.

National Bankshares, Inc.

NBI is a bank holding company qualified as a financial holding company under the Federal Bank Holding Company Act (BHCA), which is administered by the Board of Governors of the Federal Reserve System (the “Federal Reserve”). NBI is required to file an annual report with the Federal Reserve and may be required to furnish additional information pursuant to the BHCA. The Federal Reserve is authorized to examine NBI and its subsidiaries. With some limited exceptions, the BHCA requires a bank holding company to obtain prior approval from the Federal Reserve before acquiring or merging with a bank or before acquiring more than 5% of the voting shares of a bank unless it already controls a majority of shares.

The Bank Holding Company Act. Under the BHCA, a bank holding company is generally prohibited from engaging in nonbanking activities unless the Federal Reserve has found those activities to be incidental to banking. Bank holding companies also may not acquire more than 5% of the voting shares of any company engaged in nonbanking activities. Amendments to the BHCA that were included in the Gramm-Leach-Bliley Act of 1999 (see below) permitted any bank holding company with bank subsidiaries that are well-capitalized, well-managed and which have a satisfactory or better rating under the Community Reinvestment Act (see below) to file an election with the Federal Reserve to become a financial holding company. A financial holding company may engage in any activity that is (i) financial in nature (ii) incidental to a financial activity or (iii) complementary to a financial activity. Financial activities include insurance underwriting, insurance agency activities, securities dealing and underwriting and providing financial, investment or economic advising services. NBI is a financial holding company that currently engages in insurance agency activities and providing financial, investment or economic advising services.

The Virginia Banking Act. The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission (the “Commission”). NBI is required to report to the Commission with respect to financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries and must approve the acquisition of ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company.

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

The Sarbanes-Oxley Act. The Sarbanes-Oxley Act (“SOX”) enacted major reforms of the federal securities laws intended to protect investors by improving the accuracy and reliability of corporate disclosures. It impacts all companies with securities registered under the Securities Exchange Act of 1934, including NBI. SOX creates

increased responsibility for chief executive officers and chief financial officers with respect to the content of filings with the Securities and Exchange Commission. Section 404 of SOX and related Securities and Exchange Commission rules focused increased scrutiny by internal and external auditors on NBI's systems of internal controls over financial reporting, which is designed to insure that those internal controls are effective in both design and operation. SOX sets out enhanced requirements for audit committees, including independence and expertise, and it includes stronger requirements for auditor independence and limits the types of non-audit services that auditors can provide. Finally, SOX contains additional and increased civil and criminal penalties for violations of securities laws.

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

On July 2, 2013, the Federal Reserve voted to adopt final Basel III capital rules for U.S. banking organizations. The final rules establish an integrated regulatory capital framework and will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rule, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the final rule includes a new minimum ratio of common equity tier 1 capital (Tier I Common) to risk-weighted assets and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets and includes a minimum leverage ratio of 4% for all banking organizations. These new minimum capital ratios will become effective for the Company on January 1, 2015 and will be fully phased-in on January 1, 2019.

The final rule emphasizes common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The final rule also improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets. We are in the process of evaluating the impact of the Basel III final rule on the Company's regulatory capital ratios.

Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for a financial institution could subject NBB or the Company to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits and other restrictions on its business. As described above, significant additional restrictions can be imposed on NBB if it would fail to meet applicable capital requirements.

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

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

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

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

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

The National Bank of Blacksburg

NBB is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency (“OCC”). NBB’s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of NBB’s operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. NBB is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs. OCC requires NBB to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for NBB and other banks.

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

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

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

Consumer Laws and Regulations. There are a number of laws and regulations that regulate banks’ consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Electronic Funds Transfer Act and the Fair Debt Collections Practices Act. NBB is required to comply with these laws and regulations in its dealings with customers. In addition, the CFPB has begun adopting rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations.

Deposit Insurance. NBB has deposits that are insured by the FDIC. FDIC maintains a Deposit Insurance Fund (“DIF”) that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. FDIC may adjust assessments if the insured institution’s risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. Beginning April 1, 2011, an institution’s assessment base became consolidated total assets less its average tangible equity as defined by the FDIC. The FDIC has authority to impose (and has imposed during the recent financial crisis) special measures to boost the deposit insurance fund such as prepayments of assessments and additional special assessments.

After giving primary regulators an opportunity to first take action, FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution’s deposit insurance. NBB has no knowledge of any matter that would threaten its FDIC insurance coverage.

Capital Requirements. The same capital requirements that are discussed above with relation to NBI are applied to NBB by the OCC. The OCC guidelines provide that banks experiencing internal growth or making acquisitions are expected to maintain strong capital positions well above minimum levels, without reliance on intangible assets. In addition, implementation of the BASEL III requirements could increase required capital minimums as well as compliance costs due to their complexity.

Limits on Dividend Payments. A significant portion of NBI's income is derived from dividends paid by NBB. As a national bank, NBB may not pay dividends from its capital, and it may not pay dividends if the bank would become undercapitalized, as defined by regulation, after paying the dividend. Without prior OCC approval, NBB's dividend payments in any calendar year are restricted to the bank's retained net income for that year, as that term is defined by the laws and regulations, combined with retained net income from the preceding two years, less any required transfer to surplus.

The OCC and FDIC have authority to limit dividends paid by NBB if the payments are determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the bank's capital base could be deemed to be an unsafe and unsound banking practice.

Branching. As a national bank, NBB is required to comply with the state branch banking laws of Virginia, the state in which the bank is located. NBB must also have the prior approval of OCC to establish a branch or acquire an existing banking operation. Under Virginia law, NBB may open branch offices or acquire existing banks or bank branches anywhere in the state. Virginia law also permits banks domiciled in the state to establish a branch or to acquire an existing bank or branch in another state. The Dodd-Frank Act permits the OCC to approve applications by national banks like NBB to establish *de novo* branches in any state in which a bank located in that state is permitted to establish a branch.

Monetary Policy

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

Other Legislative and Regulatory Concerns

Particularly because of uncertain economic conditions and the current political environment, federal and state laws and regulations are regularly proposed that could affect the regulation of financial institutions. New regulations could add to the regulatory burden on banks and other financial service providers and increase the costs of compliance, or they could change the products that can be offered and the manner in which financial institutions do business. We cannot foresee how regulation of financial institutions may change in the future and how those changes might affect NBI.

Company Website

NBI maintains a website at www.nationalbankshares.com. The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission. The Company's proxy materials for the 2014 annual meeting of stockholders are also posted on a separate website at www.nationalbanksharesproxy.com.

Item 1A. Risk Factors

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

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

An extended economic recovery or return to recession could increase the risk of losses in our investment portfolio.

We hold both corporate and municipal bonds in our investment portfolio. A slow recovery or return to recession could increase the actual or perceived risk of default by both corporate and government issuers and, in either case, could adversely affect the value of these investments. In addition, the value of these investments could be affected by a change in interest rates and related factors, including the pricing of securities.

If the real estate market remains depressed for an extended period, our business could be negatively affected.

A depressed real estate market can impact us in several ways. First, the demand for new real estate loans will decline, and existing loans may become delinquent. In addition, if there is a general devaluation in real estate, loan collateral values will decline.

Market interest rates are currently low. If market interest rates rise, our net interest income can be negatively affected in the short term.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our information systems may experience an interruption or security breach.

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

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

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

Item 1B. Unresolved Staff Comments

There are none.

Item 2. Properties

NBB owns and has a branch bank in NBI's headquarters building located at 101 Hubbard Street, Blacksburg, Virginia. The bank's main office is at 100 South Main Street, Blacksburg, Virginia. NBB owns an additional nineteen branch offices and it leases four. NBB owns a former branch building in Tazewell, Virginia that is actively marketing for sale. NBI owns a building in Pulaski, Virginia that it rents on a month-to-month basis and is actively marketing for sale. We believe that existing facilities are adequate for current needs and to meet anticipated growth.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

Not applicable.

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the NASDAQ Capital Market under the symbol "NKSH." As of December 31, 2013, there were 756 record stockholders of NBI common stock. The following is a summary of the market price per share and cash dividend per share of the common stock of National Bankshares, Inc. for 2013 and 2012.

Common Stock Market Prices

	2013		2012		Dividends per share	
	High	Low	High	Low	2013	2012
First Quarter	\$36.97	\$31.80	\$31.16	\$25.95	\$---	\$---
Second Quarter	35.79	31.80	30.65	28.60	0.54	0.53
Third Quarter	38.89	35.14	35.82	29.18	---	---
Fourth Quarter	38.12	34.53	33.82	29.03	0.58	0.57

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

On May 14, 2013, NBI's Board of Directors approved the repurchase of up to 100,000 shares of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934. During 2013, there were no shares repurchased, and 100,000 shares may yet be purchased under the program.

Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Composite Index, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2008. These comparisons assume the investment of \$100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2008, and the reinvestment of dividends.

	2008	2009	2010	2011	2012	2013
NATIONAL BANKSHARES, INC.	100	150	173	159	192	225
NASDAQ COMPOSITE INDEX	100	145	172	170	201	281
NASDAQ BANK INDEX	100	84	96	86	102	144

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

\$ in thousands, except per share data	Year ended December 31,									
	2013	2012	2011	2010	2009					
Selected Income Statement Data:										
Interest income	\$46,127	\$48,670	\$49,946	\$49,139	\$50,487					
Interest expense	5,955	7,887	9,184	11,158	15,825					
Net interest income	40,172	40,783	40,762	37,981	34,662					
Provision for loan losses	1,531	3,134	2,949	3,409	1,634					
Noninterest income	8,836	8,818	8,489	8,426	8,883					
Noninterest expense	24,370	23,475	23,417	23,206	23,932					
Income taxes	5,317	5,245	5,247	4,223	3,660					
Net income	17,790	17,747	17,638	15,569	14,319					
Per Share Data:										
Basic net income	2.56	2.56	2.54	2.25	2.07					
Diluted net income	2.55	2.55	2.54	2.24	2.06					
Cash dividends declared	1.12	1.10	1.00	0.91	0.84					
Book value	21.00	21.60	20.36	18.63	17.61					
Selected Balance Sheet Data at End of Year:										
Loans, net	587,463	583,813	580,402	568,779	583,021					
Total securities	349,065	352,043	318,913	315,907	297,417					
Total assets	1,110,630	1,104,361	1,067,102	1,022,238	982,367					
Total deposits	960,036	946,766	919,333	884,583	852,112					
Stockholders' equity	145,892	150,109	141,299	129,187	122,076					
Selected Balance Sheet Daily Averages:										
Loans, net of unearned income and the allowance for loan losses	577,746	579,817	580,037	577,210	572,438					
Total securities	364,263	339,416	320,908	289,532	298,237					
Total assets	1,090,703	1,080,351	1,031,899	989,952	971,538					
Total deposits	933,482	925,986	888,044	852,953	846,637					
Stockholders' equity	149,491	147,812	136,794	129,003	117,086					
Selected Ratios:										
Return on average assets	1.63	%	1.64	%	1.71	%	1.57	%	1.47	%
Return on average equity	11.90	%	12.01	%	12.89	%	12.07	%	12.23	%
Dividend payout ratio	43.74	%	43.04	%	39.34	%	40.52	%	40.67	%

Average equity to average assets **13.71** % 13.68 % 13.26 % 13.03 % 12.05 %

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

\$ in thousands, except per share data

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

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

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

The recession continues to impact the national economy as well as the Company’s market. Signs of economic recovery are mixed with continued high unemployment and diminished real estate values. The Company’s trade area contains a diverse economy that includes large public colleges and universities, which somewhat insulated the Company’s market from the dramatic declines in real estate values seen in some other areas of the country. Real estate values in the Company’s market area saw moderate declines in 2009 and 2010 that appeared to stabilize in 2011 and 2012, and in 2013 showed signs of improving. Nonperforming assets as of December 31, 2013 fell from the level at December 31, 2012. If the economic recovery wavers or reverses, it is likely that unemployment will continue at higher-than-normal levels or rise in the Company’s trade area. Because of the importance to the Company’s markets of state-funded universities, cutbacks in the funding provided by the State as a result of the recession could also negatively impact employment. This could lead to an even higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company’s business and professional customers. In conclusion, a slow economic recovery could have an adverse effect on all financial institutions, including the Company.

Critical Accounting Policies

General

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

Allowance for Loan Losses

The allowance for loan losses is an accrual of estimated losses that have been sustained in our loan portfolio. The allowance is 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 able to be estimated, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

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

Impaired loans

Impaired loans are identified through the Company’s credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan’s fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral (“collateral method”), the present value of future cash flows (“cash flow method”), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is imminent 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 evaluations 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, certified and licensed, and approved by the Bank. Appraisals incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value. Appraisals are ordered and reviewed by employees independent of the lending transaction.

Internal evaluations are prepared and reviewed by employees who are independent of the loan origination, operation, management and collection functions. Evaluations provide a property’s market value based on the property’s actual physical condition and characteristics, and the economic market conditions that affect the property’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. 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. The period of time over which loss rates are averaged, or “look-back period” is 2 years. For the December 31, 2013 measurement, loss rates applied by class were obtained by averaging the loss rates for 2013 with those for 2012; loss rates for the December 31, 2012 measurement averaged loss rates from 2012 and 2011; loss rates for the December 31, 2011 measurement averaged loss rates for 2011 and 2010. The look-back period is the same for all classes and segments. Qualitative factors represented by delinquency rates, loan quality and concentrations are evaluated on a class level, with allocations based on the evaluation of trends and levels. Economic factors such as unemployment rates, bankruptcy rates and others are evaluated, with standard allocations applied consistently to relevant classes.

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

Estimation of the allowance for loan losses

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

The estimate of the allowance for December 31, 2013 considered market and portfolio conditions during 2013 as well as the elevated levels of delinquencies and net charge-offs in 2012. Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see the notes to the financial statements, "Asset Quality," and "Provision and Allowance for Loan Losses."

Goodwill and Core Deposit Intangibles

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

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

Acquired intangible assets (such as core deposit intangibles) are recognized separately from goodwill if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over its useful life. The Company

amortizes intangible assets arising from branch transactions over their useful life. Core deposit intangibles are subject to a recoverability test based on undiscounted cash flows, and to the impairment recognition and measurement provisions required for other long-lived assets held and used. The impairment testing showed that the expected cash flows of the intangible assets exceeded the carrying value.

Overview

National Bankshares, Inc. is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. The National Bank of Blacksburg (“NBB”), which does business as National Bank from twenty-five office locations, is a community bank. NBB is the source of nearly all of the Company’s revenue. National Bankshares Financial Services, Inc. (“NBFS”) does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

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

Performance Summary

The following table presents NBI's key performance ratios for the years ending December 31, 2013 and December 31, 2012:

	12/31/13		12/31/12	
Return on average assets	1.63	%	1.64	%
Return on average equity	11.90	%	12.01	%
Basic net earnings per common share	\$ 2.56		\$ 2.56	
Fully diluted net earnings per common share	\$ 2.55		\$ 2.55	
Net interest margin ⁽¹⁾	4.25	%	4.38	%
Noninterest margin ⁽²⁾	1.43	%	1.36	%

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

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

The return on average assets for the year ended December 31, 2013 was 1.63%, similar to 1.64% for the year ended December 31, 2012. The return on average equity decreased from 12.01% for the year ended December 31, 2012 to 11.90% for the year ended December 31, 2013.

Reflecting both the effects of the low interest rate environment throughout 2013 on NBI's funding costs and the Company's asset/liability management practices, the net interest margin decreased from 4.38% at year-end 2012 to 4.25% at December 31, 2013.

The noninterest margin increased from 1.36% to 1.43% over the same period, while basic net earnings per common share remained constant at \$2.56 for the years ended December 31, 2013 and 2012 respectively.

Growth

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

	12/31/13	12/31/12
Securities	\$349,065	\$352,043
Loans, net	587,463	583,813

Deposits	960,036	946,766
Total assets	1,110,630	1,104,361

Total assets experienced growth in 2013, funded by increases in customer deposits. Customer deposits grew \$13,270 or 1.40% from December 31, 2012, with increases mainly from municipal deposits and individuals seeking to safeguard principal by avoiding more volatile investments in financial markets. The liquidity provided by customer deposits supported growth in loans of \$3,650 or 0.63%. Securities declined by \$2,978 or 0.85%.

In both 2012 and 2013, the Company's growth was internally generated and was not the result of acquisitions or other borrowings.

Asset Quality

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

	12/31/13	12/31/12		
Nonperforming loans ⁽¹⁾	\$ 6,584	\$ 13,021		
Loans past due 90 days or more and accruing	190	170		
Other real estate owned	4,712	1,435		
Allowance for loan losses to loans ⁽²⁾	1.38	1.41	%	%
Net charge-off ratio	0.28	0.49	%	%

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

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

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. At December 31, 2013, nonperforming loans were \$6,584 or 1.11% of loans net of unearned income and deferred fees. This compares to \$13,021 and 2.20% at December 31, 2012. Loans past due 90 days or more and still accruing at year-end 2013 totaled \$190, an increase of \$20 or 11.76%, from \$170 at December 31, 2012. The net charge-off ratio decreased, from 0.49% for the year ended December 31, 2012 to 0.28% for the year ended December 31, 2013, while other real estate owned increased \$3,277 for the same period.

The Company's risk analysis determined an allowance for loan losses of \$8,227 at December 31, 2013, resulting in a provision for the year of \$1,531. This compares with an allowance for loan losses of \$8,349 as of December 31, 2012, and a provision of \$3,134 for the year ended December 31, 2012. The ratio of the allowance for loan losses to loans decreased to 1.38%, from 1.41% at December 31, 2012. The methodology for determining the allowance for loan losses relies on historical charge off-trends, modified by trends in nonperforming loans and economic indicators. More information about the level and calculation methodology of the allowance for loan losses is provided in "Balance Sheet – Loans – Risk Elements," "Balance Sheet – Loans – Troubled Debt Restructurings," as well as Notes 1 and 5 to the financial statements.

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

Net Interest Income

Net interest income for the period ended December 31, 2013 was \$40,172, a decrease of \$611, or 1.50%, when compared to the prior year. The net interest margin for 2013 was 4.25%, compared to 4.38% for 2012. Total interest income for the period ended December 31, 2013 was \$46,127, a decrease of \$2,543 from the period ended December 31, 2012. Interest expense declined by \$1,932 during the same time frame, from \$7,887 for the year ended December 31, 2012 to \$5,955 for the year ended December 31, 2013. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates. In addition, low-rate interest-bearing deposits volume increased substantially. Please refer to the section titled "Analysis of Changes In Interest Income and Interest Expense" for further information related to rate and volume changes.

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

During 2013, interest rates continued at historic lows. Offsetting the positive effect of low interest rates on customer deposits is the fact that some higher yielding securities in the Company's investment portfolio were called and were replaced with securities with yields at the lower market rate. Another negative effect of the low interest rate environment is the level of interest earned on overnight funds. This impacted the yield on the Company's interest-bearing deposits in other banks. The yield on these assets in 2013 was 0.27%, while the cost of

interest-bearing liabilities was 0.75% in the same period. These assets are used primarily to provide liquidity.

The primary source of funds used to support the Company's interest-earning assets is deposits. Deposits are obtained in the Company's trade area through traditional marketing techniques. Other funding sources, such as the Federal Home Loan Bank, while available, are only used occasionally. The cost of funds is dependent on interest rate levels and competitive factors. This limits the ability of the Company to react to interest rate movements.

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

Analysis of Net Interest Earnings

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the interest earned or paid, the average yield or rate on the daily average balance outstanding, net interest income and net yield on average interest-earning assets for the years indicated.

	December 31, 2013			December 31, 2012			December 31, 2011		
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
Interest-earning assets:									
Loans, net of unearned income (1)(2)(3)(4)	\$587,007	\$33,303	5.67 %	\$589,935	\$35,744	6.06 %	\$589,257	\$36,813	6.25 %
Taxable securities ⁽⁵⁾	200,040	6,707	3.35 %	167,874	6,613	3.94 %	155,765	6,745	4.33 %
Nontaxable securities ⁽¹⁾⁽⁵⁾	171,636	9,891	5.76 %	167,355	10,002	5.98 %	163,174	10,102	6.19 %
Interest-bearing deposits	80,044	213	0.27 %	94,724	240	0.25 %	64,977	155	0.24 %
Total interest-earning assets	\$1,038,727	\$50,114	4.82 %	\$1,019,888	\$52,599	5.16 %	\$973,173	\$53,815	5.53 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	\$459,340	\$3,749	0.82 %	\$420,947	\$4,167	0.99 %	\$378,971	\$4,088	1.08 %
Savings deposits	72,783	35	0.05 %	64,973	36	0.06 %	58,273	45	0.08 %
Time deposits	259,914	2,171	0.84 %	298,797	3,684	1.23 %	314,920	5,051	1.60 %
Total interest-bearing liabilities	\$792,037	\$5,955	0.75 %	\$784,717	\$7,887	1.01 %	\$752,164	\$9,184	1.22 %
Net interest income and interest rate spread		\$44,159	4.07 %		\$44,712	4.15 %		\$44,631	4.31 %
Net yield on average interest-earning assets			4.25 %			4.38 %			4.59 %

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three years presented.

- (2) Loan fees of \$843 in 2013, \$802 in 2012 and \$729 in 2011 are included in total interest income.
- (3) Nonaccrual loans are included in average balances for yield computations.
- (4) Includes loans held for sale.
- (5) Daily averages are shown at amortized cost.

Analysis of Changes in Interest Income and Interest Expense

The Company's primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other funds. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate).

	2013 Over 2012 Changes Due To			2012 Over 2011 Changes Due To		
	Rates ⁽²⁾	Volume ⁽²⁾	Net Dollar Change	Rates ⁽²⁾	Volume ⁽²⁾	Net Dollar Change
Interest income: ⁽¹⁾						
Loans	\$(2,265)	\$ (176)	\$(2,441)	\$(1,111)	\$ 42	\$(1,069)
Taxable securities	(1,067)	1,161	94	(634)	502	(132)
Nontaxable securities	(363)	252	(111)	(355)	255	(100)
Interest-bearing deposits	12	(39)	(27)	10	75	85
Increase (decrease) in income on interest-earning assets	\$(3,683)	\$ 1,198	\$(2,485)	\$(2,090)	\$ 874	\$(1,216)
Interest expense:						
Interest-bearing demand deposits	\$(775)	\$ 357	\$(418)	\$(352)	\$ 431	\$ 79
Savings deposits	(6)	5	(1)	(14)	5	(9)
Time deposits	(1,078)	(435)	(1,513)	(1,119)	(248)	(1,367)
Increase (decrease) in expense of interest-bearing liabilities	\$(1,859)	\$ (73)	\$(1,932)	\$(1,485)	\$ 188	\$(1,297)
Increase (decrease) in net interest income	\$(1,824)	\$ 1,271	\$(553)	\$(605)	\$ 686	\$ 81

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2013, 2012 and 2011.

(2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

Total interest expense declined by \$1,932, while interest income on a taxable-equivalent basis decreased \$2,485, resulting in a decrease of \$553 in taxable-equivalent net interest income when 2013 and 2012 are compared. Declining rates impacted net interest income by \$1,824, offset by increases due to favorable changes in volume of \$1,271.

The lower interest rate environment led to a decline of \$2,441 in interest income from loans. The average balance of loans decreased from \$589,935 in 2012 to \$587,007 in 2013, causing a decrease in interest income of \$176 due to volume.

Interest income on taxable securities decreased \$1,067 due to rates, offset by an increase of \$1,161 due to average volume, for a net increase of \$94 compared to 2012. The continued low interest rate environment resulted in a large number of called securities during the first half of 2013 and reduced the opportunity to reinvest the proceeds in securities with more attractive yields. Because of low yields in the securities markets and flat loan demand, the Company priced deposits accordingly.

Interest on time deposits declined \$1,513 from 2012 to 2013, with a decline of \$1,078 due to rates and \$435 attributable to volume. See "Net Interest Income" for additional information related to the decline in interest expense.

The low interest rate environment was also present in 2012 and 2011. As compared with 2011, there was a \$1,367 decline in interest expense associated with time deposits in 2012. Of the total decline, \$1,119 was due to rates, and \$248 stemmed from lower deposit volume. Management focused on deposit pricing in 2011 and took advantage of falling rates to lower interest expense.

From 2011 to 2012 interest on loans decreased by \$1,069. Loan interest income attributable to rates was \$1,111 lower, offset partially by an increase of \$42 due to volume. As compared with 2011, there was an increase of \$81 in net interest income in 2012, with an increase due to volume of \$686, offset by declines due to rate of \$605.

Interest Rate Sensitivity

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Among the tools available to management is interest rate sensitivity analysis, which provides information related to repricing opportunities. Interest rate shock simulations indicate potential economic loss due to future interest rate changes. Shock analysis is a test that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on the return on average assets and the return on average equity projected at December 31, 2013 and 2012. For purposes of this analysis, noninterest income and expenses are assumed to be flat.

Rate Shift (bp)	Return on Average Assets		Return on Average Equity	
	2013	2012	2013	2012
300	1.42%	1.13%	7.69%	8.02%
200	1.26%	1.35%	6.32%	9.53%
100	1.15%	1.56%	5.26%	10.92%
(-)100	1.13%	1.95%	4.23%	13.51%
(-)200	1.00%	1.82%	3.88%	12.61%
(-)300	0.89%	1.55%	3.64%	10.85%

Simulation analysis is another tool available to the Company to test asset and liability management strategies under rising and falling rate conditions. As a part of the simulation process, certain estimates and assumptions must be made. These include, but are not limited to, asset growth, the mix of assets and liabilities, rate environment and local and national economic conditions. Asset growth and the mix of assets can, to a degree, be influenced by management. Other areas, such as the rate environment and economic factors, cannot be controlled. In addition, competitive pressures can make it difficult to price deposits and loans in a manner that optimally minimizes interest rate risk. Therefore, actual results may vary materially from any particular forecast or shock analysis. This shortcoming is offset somewhat by the periodic reforecasting of the balance sheet to reflect current trends and economic conditions. Shock analysis must also be updated periodically as a part of the asset and liability management process.

Noninterest Income

	Year Ended		
	December 31, 2013	December 31, 2012	December 31, 2011
Service charges on deposits	\$2,563	\$ 2,594	\$ 2,617
Other service charges and fees	225	243	287

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Credit card fees	3,330	3,278	3,197
Trust fees	1,150	1,313	1,087
Bank-owned life insurance income	739	814	762
Other income	770	472	449
Realized securities gains	59	104	90
Total noninterest income	\$8,836	\$ 8,818	\$ 8,489

Service charges on deposit accounts totaled \$2,563 for the year ended December 31, 2013. This is a decline of \$31, or 1.20%, from \$2,594 for the year ended December 31, 2012. Service charges on deposit accounts decreased \$23, or 0.88%, from 2011 to 2012. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2013 decline resulted primarily from a decrease of \$20 in ATM transaction fees and a decrease of \$10 in account service charges. When the year ended December 31, 2012 is compared to the year ended December 31, 2011, a decline in ATM transaction fees of \$53, partially offset by a \$36 increase in overdraft fees accounted for the \$23 decrease. The Company removed two automatic teller machines in 2012 to obtain cost savings that are expected to exceed the associated decline in ATM fee income.

Other service charges and fees included charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees from letters of credit and income from commissions on the sale of credit life, accident and health insurance. These fees were \$225 for the year ended December 31, 2013, down by \$18, or 7.41%, from the \$243 for 2012. The total for the year ended December 31, 2012 was \$44 below the \$287 posted for the year ended December 31, 2011. The decline in 2013 and 2012 was primarily attributable to lower check sales, decreasing income by \$7 in 2013 and \$35 in 2012. This is attributed to increased customer adoption of debit cards and internet banking bill-pay. Service charges associated with letters of credit also declined in 2013, decreasing income by \$12 from 2012.

Credit card fees for the year ended December 31, 2013, were \$52 above the \$3,278 reported for the year ended December 31, 2012. From 2011 to 2012, credit card fees increased \$81, or 2.53%. The increases in 2013 and 2012 are due to increased volume of merchant transaction fees and credit card fees.

Trust fees at \$1,150 decreased by \$163 or 12.41% when the years ended December 31, 2013 and 2012 are compared, due to a large estate account that affected 2012. For the year ended December 31, 2012 trust fees were \$1,313, an increase of \$226, or 20.79%, from 2011. Trust fees are generated from a number of different types of accounts, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income varies depending on the number and type of accounts under management and financial market conditions. The mix of account types also affected the level of trust fees in 2012 and 2013.

Noninterest income from bank-owned life insurance (BOLI) decreased, from \$814 for the year ended December 31, 2012 to \$739 for 2013. BOLI income for the year ended December 31, 2011 was \$762. The Company made an additional investment of \$1,900 in 2011, influencing the increase from 2011 to 2012. Income from bank-owned life insurance was also affected by the performance of the variable rate policies.

Other income is income from smaller balance accounts that cannot be classified in another category. Some examples include net gains from the sales of fixed assets and revenue from investment and insurance sales. Other income for 2013 was \$770, an increase of \$298, or 63.14%, when compared with \$472 for the year ended December 31, 2012. The increase from 2012 to 2013 is primarily due to increases on investment commissions of \$139. Other income for 2012 increased by \$23, or 5.12%, when compared with 2011.

Realized securities net gains for the three years presented were primarily associated with called securities. The Company sold five securities in the available-for-sale accounting designation in 2013. There were no securities sold in 2012 or 2011.

Noninterest Expense

	Year Ended		
	December	December	December
	31,	31, 2012	31, 2011
	2013		
Salaries and employee benefits	\$11,978	\$ 12,005	\$ 11,357
Occupancy, furniture and fixtures	1,616	1,589	1,599
Data processing and ATM	1,700	1,593	1,701
FDIC assessment	554	475	677
Credit card processing	2,546	2,442	2,485
Intangibles amortization	1,078	1,083	1,083
Net costs of other real estate owned	296	208	518
Franchise taxes	1,083	901	780
Other operating expenses	3,519	3,179	3,217
Total noninterest expense	\$24,370	\$ 23,475	\$ 23,417

Salary and benefits expense decreased \$27, or 0.22%, from \$12,005 for the year ended December 31, 2012 to \$11,978 for 2013. The decrease is primarily the result of a \$396 decrease in health benefits expense, offset by an increase of \$327 or 3.92% in employee salaries, which were the result of normal compensation and staffing decisions. The increase of \$648, or 5.71% from 2011 to 2012 was also the result of normal compensation and staffing decisions.

Occupancy, furniture and fixtures expense was \$1,616 for the year ended December 31, 2013, an increase of \$27, or 1.70%, from the prior year. The 2012 total was \$1,589, a decrease of \$10, or 0.63%, from the \$1,599 reported at year-end 2011. The small increase in 2013 and small decrease in 2012 are reflective of the Company's emphasis on containing controllable expenses.

Data processing and ATM expense was \$1,700 in 2013, \$1,593 in 2012 and \$1,701 in 2011. The increase of \$107 or 6.72% from 2012 to 2013 resulted primarily from infrastructure upgrades. The decline from 2011 to 2012 was due to declines in maintenance expenses and communications infrastructure expenses.

When the years ended December 31, 2013 and December 31, 2012 are compared, there was an increase in the Federal Deposit Insurance Corporation Deposit Insurance Fund assessment of \$79. The total expense for 2012 was \$475, which compares with \$554 for 2013. The FDIC assessment expense for the year ended December 31, 2012 fell \$202 from \$677 for 2011. The FDIC assessment is accrued based on a method provided by the FDIC.

Credit card processing expense was \$2,546 for the period ended December 31, 2013, an increase of \$104, or 4.26% from 2012's total of \$2,442. Credit card processing expense in 2012 decreased \$43, or 1.73% from 2011. This expense is driven by the volume of credit card, debit card and merchant account transactions and by the level of merchant discount fees. It is subject to a degree of variability.

The expense for intangibles and goodwill amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2013 decreased from 2012 by \$5 or 0.46%. The expense for intangibles and goodwill amortization remained stable from 2011 to 2012.

Net costs of other real estate owned increased from \$208 for the period ended December 31, 2012 to \$296 for the year ended December 31, 2013. From 2011 to 2012, net costs of other real estate owned decreased \$310 from \$518. This expense category varies with the number of foreclosed properties owned by NBB and with the expense associated with each. It includes write-downs on other real estate owned plus other costs associated with carrying these properties, as well as net gains or losses on the sale of other real estate. In 2013, write-downs on other real estate were \$80. This compares with \$76 in 2012 and \$327 in 2011. Other real estate is initially accounted for at fair value using current valuations, which include appraisals, real estate evaluations and realtor market opinions. If new valuation information indicates a decline from the initial basis, the Company records a write-down. Other costs for these properties in 2013 were \$197, while they were \$222 in 2012. There was a total of \$19 in net losses on the sale of other real estate for 2013 and \$90 in net gains for 2012. Because the Company's market area continues to experience the effects of the prolonged recession, it is anticipated that there will be additional foreclosures in the near future. This may result in an associated increase in the costs of other real estate owned.

Franchise taxes were \$1,083 for the period ended December 31, 2013 and \$901 for 2012, an increase of \$182 or 20.20%. Franchise tax expense increased \$121 in 2012 from \$780 in 2011. Franchise tax expense in 2011 benefitted from additional deductions discovered in 2011. State bank franchise taxes are based upon total equity, which increased in both 2012 and 2013.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs and charitable donations. For the year ended December 31, 2013, other operating expenses were \$3,519. This compares with \$3,179 for 2012 and \$3,217 for 2011. The \$340 increase from 2012 to 2013 is the result of changes in several categories of expense, with no one item making a significant contribution to the total.

Income Taxes

Income tax expense for 2013 was \$5,317 compared to \$5,245 in 2012 and \$5,247 in 2011. Tax exempt income is the primary difference between expected and actual income tax expense. The Company's effective tax rates for 2013, 2012 and 2011 were 23.01%, 22.81% and 22.93%, respectively. The Company is subject to the 35% marginal tax rate. See Note 10 of the Notes to Consolidated Financial Statements for addition information relating to income taxes.

Effects of Inflation

The Company's consolidated statements of income generally reflect the effects of inflation. Since interest rates, loan demand and deposit levels are related to inflation, the resulting changes are included in net income. The most significant item which does not reflect the effects of inflation is depreciation expense. Historical dollar values used to determine depreciation expense do not reflect the effects of inflation on the market value of depreciable assets after their acquisition.

Provision and Allowance for Loan Losses

In 2013, the Company saw improvements in some asset quality indicators, including net charge-offs, classified loans, accruing loans past due 30-89 days and nonperforming assets, and weakening in other indicators such as loans rated special mention and accruing loans past due 90 days or more.

Net charge-offs decreased by \$1,200, with the ratio of net charge-offs to average loans decreasing 21 basis points, from 0.49% in 2012 to 0.28% in 2013. Classified loans declined from \$23,111 at December 31, 2012 to 19,508 at December 31, 2013, while accruing loans past due 30-89 days fell from \$4,090 at December 31, 2012 to \$2,956 at December 31, 2013. At December 31, 2013, total nonperforming assets were \$11,296, below the level of \$14,456 at

December 31, 2012. See “Balance Sheet – Loans – Risk Elements” for additional detail about nonperforming assets. Loans rated special mention increased from \$4,639 at December 31, 2012 to \$6,229 at December 31, 2013, and accruing loans past due 90 days or more increased slightly from \$170 at December 31, 2012 to \$190 at December 31, 2013.

The consideration of these factors in the Company’s internal credit risk analysis resulted in a decline of \$122 in the allowance for loan losses to \$8,227, or 1.38% of loans at December 31, 2013. At December 31, 2012, the allowance for loan losses was \$8,349, or 1.41% of loans. Taking into account the net charge-offs of \$1,653 during the twelve months ended December 31, 2013, the provision for loan losses for 2013 was \$1,531, a decrease of \$1,603 from \$3,134 for the twelve months ended December 31, 2012.

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

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

Quarterly Results of Operations

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2013, 2012 and 2011:

	2013			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	\$11,564			