NATIONAL BANKSHARES INC
Form 10-K
March 09, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

[x] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2011

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

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

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 [x]

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 [x] 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 [x] 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. [x]

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 [x]   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 [x]

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, 2011 (the last business day of the most recently completed second fiscal quarter) was approximately $166,007,713. As of February 21, 2012, the registrant had 6,939,974 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. 2011 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2012 Annual Meeting of Stockholders	Part III

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES
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Part I
$ in thousands, except per share data

Item 1. Business

History and Business

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

The National Bank of Blacksburg

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

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

At December 31, 2011, NBB had total assets of $1,063,754 and total deposits of $919,443. NBB's net income for 2011 was $17,946, which produced a return on average assets of 1.75% and a return on average equity of 13.39%. 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, 2011, 2010 and 2009 is set out in the following table.

Period	Class of Service	Percentage of Total Revenues

December 31, 2011	Interest and Fees on Loans	62.57%
	Interest on Investments	22.75%
December 31, 2010	Interest and Fees on Loans	64.22%
	Interest on Investments	21.03%
December 31, 2009	Interest and Fees on Loans	63.38%
	Interest on Investments	21.62%

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. As a result, the normally stable base of university employment is likely to be reduced. 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 layoffs within the past several years. During the past year, Volvo Heavy Trucks has begun to slowly re-hire some employees whose jobs were cut in the previous year in response to a rapid decline in the demand for trucks because of the economic downturn. 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 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, 2011, NBI employed 18 full time employees, NBB had 194 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 implementing 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, securities dealing and underwriting and providing financial, investment or economic advising services. NBI is a financial holding company.

The Virginia Banking Act. The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission (the “Commission”). NBI is required to report to the Commission with respect to financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries 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. GBLA 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 Requirements. The Federal Reserve has adopted risk-based capital guidelines that are applicable to NBI. The guidelines provide that the Company must maintain a minimum ratio of 8% of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit). At least half of total capital must be comprised of Tier 1 capital, for a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition, the

Federal Reserve has established minimum leverage ratio guidelines of 4% for banks that meet certain specified criteria. The leverage ratio is the ratio of Tier 1 capital to total average assets, less intangibles. NBI is expected to be a source of capital strength for its subsidiary bank, and regulators can undertake a number of enforcement actions against NBI if its subsidiary bank becomes undercapitalized. NBI's bank subsidiary is well capitalized and fully in compliance with capital guidelines.

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

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 will also oversee 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. In addition, the Federal Reserve issued new rules, effective October 1, 2011, that will have the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The result of these rules will be to limit the amount of interchange fee income available to the Company. 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 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. 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. In 2009, because of the troubled economy and the number of failed banks nationwide, there was pressure on the reserve ratio of the DIF. In order to rebuild the Fund and to help maintain public confidence in the banking system, on June 30, 2009, the FDIC imposed a special assessment of five basis points of NBB's FDIC insured assets, minus Tier 1 capital. The special assessment, which was in addition to regular DIF assessments was payable on September 30, 2009. In an effort to further strengthen the Fund, on November 12, 2009 the FDIC adopted a rule requiring insured depository institutions (including NBB) to prepay their estimated quarterly regular risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012 on December 30, 2009. In 2011, the method for calculating the FDIC assessment changed from deposit based to asset based.
On May 20, 2009, the FDIC announced that the increase in deposit insurance to at least $250,000 from $100,000, which became effective in October 2008, would be extended to December 31, 2013.
FDIC announced its Transaction Account Guarantee Program on October 14, 2008. On July 21, 2010, the Dodd-Frank Act made the increase permanent and made it retroactive to January 1, 2008. The Transaction Account Guarantee Program, which was a part of the Temporary Liquidity Guarantee Program, provided unlimited coverage for noninterest bearing deposit accounts for FDIC-insured institutions that elected to participate. NBB elected to participate in this program, and its DIF assessments increased to reflect the additional FDIC coverage. The Dodd-Frank Act expanded the program to all FDIC insured depository institutions and extended it until December 31, 2012.
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.

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 2012 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 is delayed, our credit risk will increase and there could be greater loan losses.
A slow economic recovery 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 could increase the risk of losses in our investment portfolio.
We hold both corporate and municipal bonds in our investment portfolio. A slow recovery 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.

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).

A large number of bank failures nationwide could significantly increase the cost of FDIC insurance.
Since insured depositary 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. 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. 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, 2011, there were 807 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 2011 and 2010.

Common Stock Market Prices

	2011			2010			Dividends per share	
		High	Low		High	Low	2011	2010
First Quarter	$	31.80	27.46	$	29.15	23.01	$ ---	$ ---
Second Quarter		29.71	24.08		28.50	22.96	0.48	0.44
Third Quarter		27.23	22.93		25.88	21.76	---	---
Fourth Quarter		29.00	23.21		32.28	25.39	0.52	0.47

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 11, 2011, 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 2011, 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 Index, a peer group index comprised of southeastern independent community banks and bank holding companies, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2006. These comparisons assume the investment of $100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2006, and the reinvestment of dividends. This year the stock performance graph reflects a change made by the Company in the peer group comparison index from the Independent Bank Index to the NASDAQ Bank Index. Management believes that the NASDAQ Bank Index, which consists primarily of financial institutions whose stock trades on the NASDAQ Capital Market or the NASDAQ National Market, provides a better peer group comparison because it includes geographically diverse financial institutions more comparable to the Company in asset size and trading markets than the Independent Bank Index, which consists of comparable financial institutions but is limited to the southeastern region of the United States.

	2006	2007	2008	2009	2010	2011
NATIONAL BANKSHARES, INC.	100	74	88	132	152	140
NASDAQ COMPOSITE INDEX	100	111	66	97	114	113
NASDAQ BANK INDEX	100	80	63	53	60	54
INDEPENDENT BANK INDEX	100	77	51	52	55	47

The peer group Independent Bank Index is the compilation of the total return to stockholders over the past five years of the following group of 21 independent community banks and bank holding companies located in the southeastern states of Alabama, Florida, Georgia, North Carolina, South Carolina, Tennessee, Virginia and West Virginia. The banks and bank holding companies are: American National Bankshares, Inc., Auburn National Bancorporations, Inc., BNC Bancorp, C&F Financial Corporation, Carolina Trust Bank, Central Virginia Bankshares, Inc., Community First, CNB Corporation, Fidelity Southern Corporation, First Century Bankshares, Inc., Four Oaks Fincorp, Inc., Geer Bancshares Incorporated, Monarch Financial Holdings, Inc., National Bankshares, Inc., New Bridge Bancorp, Peoples Bancorporation, Inc., Savannah Bancorp, Inc., Southeastern Banking Corporation, Southwest Georgia Financial Corp., United Security Bancshares, Inc. and Uwharrie Capital Corp.

Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries
Selected Consolidated Financial Data

$ in thousands, except per share data	Years ended December 31,				
	2011	2010	2009	2008	2007
Selected Income Statement Data:					
Interest income	$ 49,946	$ 49,139	$ 50,487	$ 50,111	$ 50,769
Interest expense	9,184	11,158	15,825	18,818	21,745
Net interest income	40,762	37,981	34,662	31,293	29,024
Provision for loan losses	2,949	3,409	1,634	1,119	423
Noninterest income	8,410	8,347	8,804	9,087	8,760
Noninterest expense	23,338	23,127	23,853	22,023	20,956
Income taxes	5,247	4,223	3,660	3,645	3,730
Net income	17,638	15,569	14,319	13,593	12,675
Per Share Data:					
Basic net income	2.54	2.25	2.07	1.96	1.82
Diluted net income	2.54	2.24	2.06	1.96	1.82
Cash dividends declared	1.00	0.91	0.84	0.80	0.76
Book value	20.36	18.63	17.61	15.89	15.07
Selected Balance Sheet Data at End of Year:					
Loans, net	580,402	568,779	583,021	569,699	518,435
Total securities	318,913	315,907	297,417	264,999	273,343
Total assets	1,067,102	1,022,238	982,367	935,374	887,647
Total deposits	919,333	884,583	852,112	817,848	776,339
Stockholders’ equity	141,299	129,187	122,076	110,108	104,800
Selected Balance Sheet Daily Averages:					
Loans, net	580,037	577,210	572,438	533,190	505,070
Total securities	320,908	289,532	298,237	281,367	282,734
Total assets	1,031,899	989,952	971,538	899,462	867,061
Total deposits	888,044	852,953	846,637	783,774	758,657
Stockholders’ equity	136,794	129,003	117,086	108,585	100,597
Selected Ratios:					
Return on average assets	1.71 %	1.57 %	1.47 %	1.51 %	1.46 %
Return on average equity	12.89 %	12.07 %	12.23 %	12.52 %	12.60 %
Dividend payout ratio	39.34 %	40.52 %	40.67 %	40.78 %	41.80 %
Average equity to average assets	13.26 %	13.03 %	12.05 %	12.07 %	11.60 %

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," "proje "contemplates," "anticipates," "forecasts," "intends," or other similar words or terms are intended to identify forward-lookin 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. Nonperforming assets increased during 2009 and 2010 but decreased in 2011. If the economic recovery wavers or reverses, it is likely that unemployment will continue at higher-than-normal levels or rise in the Company's trade area. Because of the

importance to the Company's markets of state-funded universities, cutbacks in the funding provided by the State as a result of the recession could also negatively impact employment. This could lead to an even higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company's business and professional customers. In conclusion, a slow economic recovery could have an adverse effect on all financial institutions, including the Company.

Critical Accounting Policies

General

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

Allowance for Loan Losses

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

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

Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan’s fair value. Fair value of an impaired loan is measured by one of three methods, the fair value (less cost to sell) of collateral, the present value of future cash flows, or observable market price. For loans that are not collateral-dependent (loans for which collection is solely dependent upon the sale of collateral), the potential loss is accrued in the allowance. For collateral-dependent loans, the potential loss is charged off against the allowance, instead of being accrued. Impaired loans with partial charge-offs are maintained as impaired until it becomes evident that the borrower can repay the remaining balance of the loan according to the terms.

For impaired loans for which the collateral method is elected, the Company requires a current third-party appraisal of “as is” value. If an existing appraisal is older than 12 months, a new appraisal is ordered immediately after the date of impairment designation. If a current appraisal cannot be obtained prior to reporting deadlines, the existing appraisal is discounted according to published independent indices. The Company believes this serves as a conservative estimate of fair value until the updated appraisal can be obtained.

Impaired loans are measured for impairment at least quarterly. Loss reserves and nonaccrual designation, or partial charge-off for estimated losses on impaired loans are recorded at the first measurement date and at each measurement date thereafter.

In the third quarter of 2010, the Company revised its policy for evaluation of non-impaired loans. The policy formalized criteria used to group loans for purposes of estimating losses; provided for analysis of trends and current levels of risk indicators; and designated loans that the Company determines to have inherently higher risk.

Non-impaired loans are grouped according to risk characteristic into portfolio segments and loan classes. Loans within a segment or class have similar risk characteristics. Each segment and class is evaluated for probable loss by applying quantitative and qualitative factors, including net charge-off trends, delinquency rates, concentration trends and economic trends. Net charge-off trends are evaluated by segment within a two to three year time frame, resulting in an accrual that is influenced not only by current year levels, but by prior years’ levels as well. The Company accrues additional reserves for criticized loans within each class and for loans designated high risk. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with payments of interest-only required. Both classified loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

The 2010 change in methodology did not materially affect the total estimated accrual; however, previously unallocated amounts became allocated with the new methodology.

The estimation of the accrual involves analysis of internal and external variables, methodologies, assumptions and our judgment and experience. Key judgments used in determining the allowance for loan losses include internal risk ratings, market and collateral values, discount rates, loss rates, and our view of current economic conditions. The inherent subjectivity of these judgments, as well as the lagging of credit quality measurements relative to the performance of the loan portfolio, create a degree of imprecision. 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.
Given the continued economic difficulties, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 5 of the Notes to Consolidated Financial Statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

Goodwill and Core Deposit Intangibles

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter. 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, 2011 and December 31, 2010:

	12/31/11	12/31/10
Return on average assets	1.71 %	1.57 %
Return on average equity	12.89 %	12.07 %
Basic net earnings per common share	$ 2.54	$ 2.25
Fully diluted net earnings per common share	$ 2.54	$ 2.24
Net interest margin (1)	4.59 %	4.52 %
Noninterest margin (2)	1.45 %	1.49 %

(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, 2011 was 1.71%, an increase of 14 basis points from the 1.57% for the year ended December 31, 2010. The return on average equity increased from 12.07% for the year ended December 31, 2010 to 12.89% for the year ended December 31, 2011.

Reflecting both the effects of the low interest rate environment throughout 2011 on NBI's funding costs and the Company's asset/liability management practices, the net interest margin increased from 4.52% at year-end 2010 to

4.59% at December 31, 2011.

The noninterest margin decreased from 1.49% to 1.45% over the same period due to a decrease in FDIC assessments. Please refer to the discussion of “Noninterest Expense” for additional details about FDIC assessments.

Overall, the higher net interest margin, is largely responsible for the increase in basic net earnings per common share, from $2.25 for the year ended December 31, 2010 to $2.54 for the year ended December 31, 2011.

Growth

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

	12/31/11	12/31/10
Securities	$ 318,913	$ 315,907
Loans, net	580,402	568,779
Deposits	919,333	884,583
Total assets	1,067,102	1,022,238

Securities, loans, and total assets all experienced growth in 2011, primarily funded by increases in customer deposits. Customer deposits grew $34,750 or 3.93% from December 31, 2010, 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 $11,623 or 2.04% and securities of $3,006 or 0.95%, with the excess funds held in the Company's interest-bearing deposits.

In both 2010 and 2011, the Company's growth was internally generated and was not the result of acquisitions.

Asset Quality

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

	12/31/11	12/31/10
Nonperforming loans(1)	$ 5,204	$ 8,071
Loans past due 90 days or more and accruing	481	1,336
Other real estate owned	1,489	1,723
Allowance for loan losses to loans(2)	1.37 %	1.33 %
Net charge-off ratio	0.43 %	0.46 %

(1) In 2011, the Company changed its definition of nonperforming loans to nonaccrual loans plus restructured loans in nonaccrual status. Accruing restructured loans are not included. In prior years, the Company reported nonperforming loans as the total of nonaccrual loans plus all restructured loans. For comparison purposes, nonperforming loans, nonperforming assets and all associated ratios have been restated for prior years consistent with the definition adopted in 2011.

(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. In 2011, the Company's asset quality showed signs of improvement. Nonperforming loans were $5,204 or 0.88% of loans net of unearned income and deferred fees. This compares to $8,071 and 1.40% at December 31, 2010. Loans past due 90 days or more and still accruing at year-end 2011 totaled $481, a decrease of $855 or 64.00%, from $1,336 at December 31, 2010. The net charge-off ratio also declined, from 0.46% for the year ended December 31, 2010 to 0.43% for 2011, while other real estate owned declined $234 or 13.58% for the same period.

The Company's risk analysis determined an allowance for loan losses of $8,068 at December 31, 2011, resulting in a provision for the year of $2,949, a decrease of $460 or 13.49% from the $3,409 for 2010. While levels of nonperforming and charged-off loans decreased in 2011, the ratio of the allowance for loan losses to loans increased to 1.37%, from 1.33% at December 31, 2010. The methodology for determining the allowance for loan losses relies on historical charge off-trends, modified by trends in nonperforming loans and economic indicators. The declines in risk indicators in 2011 were tempered by the higher levels of the recent past, resulting in a higher allowance for loan losses at December 31, 2011. 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," a 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, 2011 was $40,762, an increase of $2,781, or 7.32%, when compared to the prior year. The net interest margin for 2011 was 4.59%, compared to 4.52% for 2010. Total interest income for the period ended December 31, 2011 was $49,946, an increase of $807 from the period ended December 31, 2010. Interest expense was down by $1,974 during the same time frame, from $11,158 for 2010 to $9,184 for the year ended December 31, 2011. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates. In addition, noninterest-bearing deposits and 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. In summary, the rates paid on the Company's deposit liabilities declined at a more rapid pace than the interest rates on its interest-earning assets.

The amount of net interest income earned is affected by various factors, including changes in market interest rates due to the Federal Reserve Board's monetary policy, the level and composition of the earning assets, and 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 2011, interest rates continued at historic lows. Offsetting the positive effect of low interest rates is the fact that some higher yielding securities in the Company's investment portfolio were called and were replaced with securities yielding at the lower market rate. Another negative effect of the low interest rate environment is the level of interest earned on overnight funds. These assets are used primarily to provide liquidity. The yield on these assets in 2011 was 0.24%, while the cost to fund them was 0.94% in the same period.

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.

If the volume of interest-bearing liabilities remains at December 31, 2011 levels and the current low interest rate environment remains stable, management does not anticipate any further improvement in the net interest margin. 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, 2011			December 31, 2010			December 31, 2009		
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
Interest-earning assets:									
Loans, net (1)(2)(3)	$ 589,257	$ 36,813	6.25 %	$ 585,933	$ 37,282	6.36 %	$ 579,581	$ 37,903	6.54 %
Taxable securities	155,765	6,745	4.33 %	123,920	5,588	4.51 %	134,607	6,273	4.66 %
Nontaxable securities (1)(4)	163,174	10,102	6.19 %	161,571	10,074	6.24 %	162,889	10,154	6.23 %
Interest-bearing deposits	64,977	155	0.24 %	55,477	128	0.23 %	35,841	90	0.25 %
Total interest-earning assets	$ 973,173	$ 53,815	5.53 %	$ 926,901	$ 53,072	5.73 %	$ 912,918	$ 54,420	5.96 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	$ 378,971	$ 4,088	1.08 %	$ 322,705	$ 3,332	1.03 %	$ 282,532	$ 3,076	1.09 %
Savings deposits	58,273	45	0.08 %	54,543	51	0.09 %	48,992	52	0.11 %
Time deposits	314,920	5,051	1.60 %	352,887	7,775	2.20 %	399,873	12,694	3.17 %
Short-term borrowings	---	---	--- %	---	---	--- %	49	3	6.12 %
Total interest-bearing liabilities	$ 752,164	$ 9,184	1.22 %	$ 730,135	$ 11,158	1.53 %	$ 731,446	$ 15,825	2.16 %
Net interest income and interest rate spread		$ 44,631	4.31 %		$ 41,914	4.20 %		$ 38,595	3.80 %
Net yield on average interest-earning assets			4.59 %			4.52 %			4.23 %

(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 $729 in 2011, $863 in 2010 and $956 in 2009 are included in total interest income.
(3) Nonaccrual loans are included in average balances for yield computations.

(4) 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).

	2011 Over 2010 Changes Due To			2010 Over 2009 Changes Due To		
	Rates(2)	Volume(2)	Net Dollar Change	Rates(2)	Volume(2)	Net Dollar Change
Interest income: (1)						
Loans	$ (680)	$ 211	$ (469)	$ (1,033)	$ 412	$ (621)
Taxable securities	(229)	1,386	1,157	(198)	(487)	(685)
Nontaxable securities	(71)	99	28	2	(82)	(80)
Interest-bearing deposits	4	23	27	(8)	46	38
Increase (decrease) in income on interest-earning assets	$ (976)	$ 1,719	$ 743	$ (1,237)	$ (111)	$ (1,348)
Interest expense:						
Interest-bearing demand deposits	$ 154	$ 602	$ 756	$ (165)	$ 421	$ 256
Savings deposits	(9)	3	(6)	(7)	6	(1)
Time deposits	(1,952)	(772)	(2,724)	(3,553)	(1,366)	(4,919)
Short-term borrowings	---	---	---	---	(3)	(3)
Increase (decrease) in expense of interest-bearing liabilities	$ (1,807)	$ (167)	$ (1,974)	$ (3,725)	$ (942)	$ (4,667)
Increase in net interest income	$ 831	$ 1,886	$ 2,717	$ 2,488	$ 831	$ 3,319

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2011, 2010 and 2009.
(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 $1,974, while interest income increased $743, resulting in an increase of $2,717 in net interest income when 2011 and 2010 are compared. Of this increase, $831 was attributable to rates, and $1,866 came from higher volume.

The lower interest rate environment led to a decline of $680 in interest income from loans. The average balance of loans increased from $585,933 in 2010 to $589,257 in 2011, causing an increase in interest income of $211, on a taxable-equivalent basis. The net decrease in loan interest income was $469.

Interest income on taxable securities decreased $229 due to rates but increased $1,386 because of average volume, for a net increase of $1,157 compared to 2010. The low interest rate environment increased the number of called securities in 2011 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 $2,724 from 2010 to 2011, with a decline of $1,952 due to rates and $772 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 2009. As compared with 2009, there was a $4,919 decline in interest expense associated with time deposits in 2010. Of the total decline, $3,553 was due to rates, and $1,366 stemmed from lower deposit volume. Management focused on deposit pricing in 2009 and took advantage of falling rates to lower interest expense.

From 2009 to 2010 interest on loans decreased by $621. Loan interest income attributable to rates was $1,033 lower, offset to a large degree by an increase of $412 due to volume. As compared with 2009, there was an increase of $3,319 in net interest income in 2010, $2,488 of the increase was due to rates and $831 due to volume.

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, 2011 and 2010. 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	
	2011	2010	2011	2010
300	0.96%	1.04%	6.96%	7.93%
200	1.13%	1.22%	8.19%	9.28%
100	1.30%	1.40%	9.32%	10.54%
(-)100	1.62%	1.70%	11.51%	12.68%
(-)200	1.58%	1.62%	11.23%	12.12%
(-)300	1.46%	1.50%	10.39%	11.27%

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, 2011	December 31, 2010	December 31, 2009
Service charges on deposits	$ 2,617	$ 2,858	$ 3,314
Other service charges and fees	287	317	343
Credit card fees	3,197	2,954	2,803
Trust fees	1,087	1,118	1,053
Bank-owned life insurance income	762	760	756
Other income	449	354	491
Realized securities gains (losses)	11	(14)	44
Total noninterest income	$ 8,410	$ 8,347	$ 8,804

Service charges on deposit accounts totaled $2,617 for the year ended December 31, 2011. This is a decline of $241, or 8.43%, from $2,858 for the year ended December 31, 2010. Service charges on deposit accounts decreased $456, or 13.76%, from 2009 to 2010. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2011 and 2010 declines resulted from a decrease in fees from checking account overdrafts and fees for checks returned for insufficient funds. This decline was caused by two factors. First, we believe consumers have become more conscientious about managing bank accounts so as to avoid overdraft fees in a challenging economy. Second, and to a lesser extent, in mid-2010 banking regulations were changed to prevent all banks, including NBB, from charging overdraft fees associated with ATM or debit card transactions.

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 $287 for the year ended December 31, 2011, down by $30, or 9.46%, from the $317 for 2010. The total for the year ended December 31, 2010 was $26 below the $343 posted for the year ended December 31, 2009. The decline in 2011 was primarily attributable to lower check sales in 2011, decreasing income by $46. This in turn, was attributed to increased customer adoption of debit cards and internet banking bill-pay. The decline from 2009 to 2010 was the result of small changes in income from several categories of fees, none of which is significant by itself.

Credit card fees for the year ended December 31, 2011, were $243 above the $2,954 reported for the year ended December 31, 2010. From 2009 to 2010, credit card fees increased $151, or 5.39%. The increases in 2011 and 2010 are due to increased volume of merchant transaction fees and credit card fees.

Trust fees, at $1,087, decreased slightly by $31, or 2.77%, when the years ended December 31, 2011 and 2010 are compared. For the year ended December 31, 2010 trust fees were $1,118, an increase of $65, or 6.17%, from 2009. 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 significant volatility in the financial markets in 2009 negatively affected Trust fee income in that year. Recovering financial markets in 2010 and 2011, while still volatile, resulted in higher levels of Trust fee income. The mix of account types also affected the level of Trust fees in 2010 and 2011.

Noninterest income from bank-owned life insurance (BOLI) remained virtually unchanged, from $760 for the year ended December 31, 2010 to $762 for 2011. It grew slightly from $756 to $762 from December 31, 2009 to December 31, 2010. The performance of the variable rate policies are the source of growth in BOLI income for 2011 and 2010.
Other income is income that cannot be classified in another category. Some examples include net gains from the sales of fixed assets, rent from foreclosed properties and revenue from investment and insurance sales. Other income for the year 2011 was $449, an increase of $95, or 26.84%, when compared with $354 for the year ended December 31, 2010. Other income for 2010 decreased by $137, or 27.90%, when compared with 2009. The increase from 2010 to 2011 was primarily due to refunds of prior years' franchise taxes from additional deductions discovered in 2011.
Realized securities net gains and losses for the three years presented were associated with called securities. There were no securities sold in 2011, 2010 or 2009.

Noninterest Expense

		Year Ended	
	December 31, 2011	December 31, 2010	December 31, 2009
Salaries and employee benefits	$ 11,357	$ 10,963	$ 11,336
Occupancy, furniture and fixtures	1,599	1,875	1,792
Data processing and ATM	1,701	1,499	1,371
FDIC assessment	677	1,080	1,727
Credit card processing	2,485	2,300	2,121
Intangibles amortization	1,083	1,083	1,093
Net costs of other real estate owned	518	214	393
Franchise taxes	780	963	885
Other operating expenses	3,137	3,150	3,135
Total noninterest expense	$ 23,338	$ 23,127	$ 23,853

Salary and benefits expense increased $394, or 3.59%, from $10,963 for the year ended December 31, 2010 to $11,357 for 2011. The increase is partially the result of $141 increase in fringe benefits, offset by a decrease of $94 in net periodic pension expense associated with the Company's defined benefit pension plan. Net periodic expense varies because of changes in the number of plan participants, the age of participants, the investment performance of the plan trust and the interest rate environment. The remaining increase in 2011 was the result of normal compensation and staffing decisions. The decline of $373 from 2009 to 2010 was the result of the Company's efforts to control salary costs and a decrease of $94 in net periodic pension expense.
Occupancy, furniture and fixtures expense was $1,599 for the year ended December 31, 2011, a decrease of $276, or 14.72%, from the prior year. The 2010 total was $1,875, an increase of $83, or 4.63%, from the $1,792 reported at year-end 2009. The decline in 2011 and small increase in 2010 are reflective of the Company's emphasis on containing controllable expenses.
Data processing and ATM expense was $1,701 in 2011, $1,499 in 2010 and $1,371 in 2009. The increase of $202 or 13.48% from 2010 to 2011 was associated with increased costs for communications because of infrastructure upgrades.
When the years ended December 31, 2011 and December 31, 2010 are compared, there was a decrease in the Federal Deposit Insurance Corporation Deposit Insurance Fund assessment of $403. The total expense for 2010 was $1,080, which compares with $677 for 2011. The FDIC assessment is accrued based on a method provided by the FDIC. During 2011, the method changed from a deposit based to an asset based method. This resulted in a reduced amount of expense for the Company in 2011. The FDIC assessment expense for the year ended December 31, 2010 fell $647 from $1,727 for 2009, due to a one-time special assessment required in 2009 of all FDIC-insured banks, including NBB. Given the severe impact of the economic downturn on some of the nation's banks, the Company has no assurance that the FDIC will not increase assessments on insured banks to maintain the integrity of the Deposit

Insurance Fund.

Credit card processing expense was $2,485 for the period ended December 31, 2011, an increase of $185, or 8.04% from 2010's total of $2,300. Credit card processing expense in 2010 increased $179, or 8.44% from 2009. 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 2011 remained flat from 2010 at $1,083. Intangibles and goodwill amortization declined $10 when the periods ended December 31, 2010 and December 31, 2009 are compared. The decline was due to certain expenses from past transactions becoming fully amortized in 2009.

Net costs of other real estate owned increased from $214 for the period ended December 31, 2010 to $518 in 2011. From 2009 to 2010, net costs of other real estate owned decreased $179 from $393. 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 2011, write-downs on other real estate were $327. This compares with $34 in 2010. The Company accounts for other real estate at the lower of cost or fair value, using current appraisals. Updated appraisals reflected declines in the value of some properties. Other costs for these properties in 2011 were $184, while they were $151 in 2010. There was a total of $7 in net losses on the sale of other real estate for 2011 and $29 in net losses for 2010. 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 $780 for the period ended December 31, 2011 and $963 for 2010, a decrease of $183 or 19.00%. The decrease was due to additional deductions discovered in 2011. Franchise tax expense increased $78 in 2010 from $885 in 2009. State bank franchise taxes are based upon total equity, which increased in both 2010 and 2011.

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, 2011, other operating expenses were $3,137. This compares with $3,150 for 2010 and $3,135 for 2009. The nominal $13 decrease from 2010 to 2011 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 2011 was $5,247 compared to $4,223 in 2010 and $3,660 in 2009. Tax exempt income is the primary difference between expected and actual income tax expense. The Company's effective tax rates for 2011, 2010 and 2009 were 22.93%, 21.34% and 20.36%, 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 2011, the Company saw improvements in asset quality indicators, after several years that were negatively impacted by the national recession and its effects on the local economy. Historically, national economic downturns have affected the Company's market area less severely than other areas of the country. In addition, downturns and recoveries in the national economy typically have a delayed effect on the Company's local economy.

At December 31, 2011, total nonperforming assets were $6,693 compared to $9,794 at December 31, 2010. See "Balance Sheet – Loans – Risk Elements" for additional detail about nonperforming assets. Net charge-offs decreased by $126, with the ratio of net charge-offs to average loans decreasing 3 basis points, from 0.46% in 2010 to 0.43% in 2011.

The Company's internal credit risk analysis takes into consideration trends in nonperforming loans and charge-offs. Based on the analysis, the Company increased the allowance for loan losses to $8,068, or 1.37% of loans at December 31, 2011. At December 31, 2010, the allowance for loan losses was $7,664, or 1.33% of loans. The provision for loan losses for 2011 was $2,949, a decrease of $460 from 2010.

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.

Balance Sheet

On December 31, 2011, the Company had total assets of $1,067,102, an increase of $44,864, or 4.39%, over the total of $1,022,238 on December 31, 2010. For 2011, the growth in assets was entirely internally generated and was not the result of acquisitions. Total assets at December 31, 2010 were up by $39,871, or 4.06%, over the total in 2009.

Loans

In 2011, the Company re-categorized its loan presentations to better reflect the Company's approach to portfolio management. The new categorization includes six groups. Real estate construction loans include construction loans for residential and commercial properties, as well as land. Consumer real estate loans include conventional and junior lien mortgages as well as equity lines. Commercial real estate loans are comprised of owner-occupied and leased nonfarm, nonresidential properties, multi-family residence loans and farmland. Commercial non real estate loans include farm loans, operating capital lines and loans secured by capital assets. Public sector and IDA loans are extended to municipalities. Consumer non real estate loans include automobile loans, personal loans, credit cards and consumer overdrafts.
The categorization of loans for this section and the balance sheet is different from the categorization used to determine the allowance for loan losses. While the categories may be similar, the allowance for loan losses methodology takes a risk-based approach to determining segments and classes for loss analysis. Determination of the categories for the balance sheet and this section is based on collateral type.

A. Types of Loans

	December 31,				
	2011	2010	2009	2008	2007
Real estate construction	$ 48,531	$ 46,169	$ 44,744	$ 60,798	$ 46,697
Consumer real estate	150,224	153,405	154,380	152,482	148,128
Commercial real estate	303,192	293,171	293,229	277,511	245,324
Commercial non real estate	38,832	37,547	41,402	36,978	33,117
Public sector and IDA	15,571	12,553	19,207	11,518	11,098
Consumer non real estate	33,072	34,543	38,047	37,393	40,409
Total loans	$ 589,422	$ 577,388	$ 591,009	$ 576,680	$ 524,773
Less unearned income and deferred fees	(952)	(945)	(1,062)	(1,123)	(1,119)
Total loans, net of unearned income	$ 588,470	$ 576,443	$ 589,947	$ 575,557	$ 523,654
Less allowance for loans losses	(8,068)	(7,664)	(6,926)	(5,858)	(5,219)
Total loans, net	$ 580,402	$ 568,779	$ 583,021	$ 569,699	$ 518,435

B. Maturities and Interest Rate Sensitivities

The following table presents maturities and interest rate sensitivities for commercial non real estate, commercial real estate and real estate construction loans.

	December 31, 2011			
	< 1 Year	1 – 5 Years	After 5 Years	Total
Commercial non real estate	$ 21,438	$ 15,839	$ 1,555	$ 38,832
Commercial real estate	45,731	248,628	8,833	303,192
Real estate construction	47,114	1,417	---	48,531
Total	114,283	265,884	10,388	390,555
Less loans with predetermined interest rates	(24,138)	(25,549)	(6,435)	(56,122)
Loans with adjustable rates	$ 90,145	$ 240,335	$ 3,953	$ 334,433

C. Risk Elements

The following table presents aggregate amounts for nonaccrual loans, restructured loans in nonaccrual, other real estate owned net, and accruing loans which are contractually past due ninety days or more as to interest or principal payments, and accruing restructured loans.

	December 31,				
	2011	2010	2009	2008	2007
Nonaccrual loans:					
Real estate construction	$ ---	$ ---	$ 2,643	$ ---	$ ---
Consumer real estate	296	964	---	---	---
Commercial real estate	702	526	1,455	1,333	1,144
Commercial non-real estate	400	448	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non-real estate	---	---	---	---	6
Total nonaccrual loans	$ 1,398	$ 1,938	$ 4,098	$ 1,333	$ 1,150
Restructured loans (TDR Loans) in nonaccrual					
Real estate construction	$ 1,681	$ 2,185	$ ---	$ ---	$ ---
Consumer real estate	315	---	---	---	---
Commercial real estate	1,544	3,698	---	---	---
Commercial non-real estate	198	250	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non-real estate	68	---	---	---	---
Total restructured loans in nonaccrual	3,806	6,133	---	---	---
Total nonperforming loans	$ 5,204	$ 8,071	$ 4,098	$ 1,333	$ 1,150
Other real estate owned, net	1,489	1,723	2,126	1,984	263
Total nonperforming assets	$ 6,693	$ 9,794	$ 6,224	$ 3,317	$ 1,413
Accruing loans past due 90 days or more:					
Real estate construction	$ ---	$ ---	$ 20	$ ---	$ ---
Consumer real estate	346	612	873	394	310
Commercial real estate	63	577	643	589	614
Commercial non-real estate	26	81	99	74	115
Public sector and IDA	---	---	---	---	---
Consumer non-real estate	46	66	62	70	142
	$ 481	$ 1,336	$ 1,697	$ 1,127	$ 1,181
Accruing restructured loans:					
Real estate construction	$ 1,611	$ ---	$ ---	$ ---	$ ---
Consumer real estate	156	---	---	---	---
Commercial real estate	1,922	350	2,652	---	---
Commercial non-real estate	67	---	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non-real estate	---	---	---	---	---
	$ 3,756	$ 350	$ 2,652	$ ---	$ ---

Loan loss and other indicators related to asset quality are presented in the Loan Loss Data table.

Loan Loss Data Table

		2011			2010			2009	
Provision for loan losses	$	2,949		$	3,409		$	1,634	
Net charge-offs to average net loans		0.43	%		0.46	%		0.10	%
Allowance for loan losses to loans, net of unearned income and deferred fees		1.37	%		1.33	%		1.17	%
Allowance for loan losses to nonperforming loans		155.03	%		94.96	%		168.99	%
Allowance for loan losses to nonperforming assets		120.54	%		78.25	%		111.27	%
Nonperforming assets to loans, net of unearned income and deferred fees, plus other real estate owned		1.13	%		1.69	%		1.05	%
Nonaccrual loans	$	1,398		$	1,938		$	4,098	
Restructured loans in nonaccrual status		3,806			6,133			---	
Other real estate owned, net		1,489			1,723			2,126	
Total nonperforming assets	$	6,693		$	9,794		$	6,224	
Accruing loans past due 90 days or more	$	481		$	1,336		$	1,697	

Nonperforming loans include nonaccrual loans and restructured loans ("troubled debt restructurings" or "TDR loans") in nonaccrual status, but do not include accruing loans 90 days or more past due or accruing restructured loans. Troubled debt restructurings are discussed in detail under the section titled "D. Troubled Debt Restructurings (TDR Loans)" below. Impaired loans, or loans for which management does not expect to collect at the original loan terms, but which may or may not be nonperforming, are presented in Note 5 of Notes to Consolidated Financial Statements.

Total impaired loans at December 31, 2011 were $12,596, of which $5,089 were in nonaccrual status. Impaired loans at December 31, 2010 and 2009 were $8,791 and $7,680, of which $7,612 and $4,098 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans increased from 94.96% in 2010 to 155.03% in 2011. The 31.66% decline in nonperforming assets resulted in the increase in the coverage of the allowance for loan losses to nonperforming assets. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

D. Troubled Debt Restructurings (TDR Loans)

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

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

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

For a loan modification to be a TDR, the following three conditions must all be present: (1) the borrower is experiencing financial difficulty, (2) the Company makes a concession to the original contractual loan terms, and (3) the concessions are for economic or legal reasons related to the borrower's financial difficulty that the Company would not otherwise consider.

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

Assuming all other TDR criteria are met, the Corporation considers one or a combination of the following concessions to the loan terms to indicate TDR status: a reduction of the stated interest rate, an extension of the maturity date at an interest rate lower than the current market rate for a new loan with a similar term, or forgiveness of principal or accrued interest.

The Company recognizes that the current economy, elevated levels of unemployment and depressed real estate values have resulted in many customers experiencing financial difficulties. The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure.

The Company had $7,562 in TDRs as of December 31, 2011 and $6,483 as of December 31, 2010. Accruing TDR loans amounted to $3,756 at December 31, 2011 compared to $350 at December 31, 2010. All TDR loans are specifically assessed for impairment for purposes of determining the allowance for loan losses. TDR loans with an impairment loss are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

Restructuring generally results in loans with either lower payments or an extended maturity beyond that originally required, and are expected to have a lower risk of loss due to nonperformance than loans classified as nonperforming. The Company's experience with TDR loan performance is relatively new, and it has not yet gained historical experience with TDR loans sufficient to establish firm default trends. In 2011, the Company modified $2,999 in troubled debt restructurings. Of these, $2,852 subsequently defaulted. The Company defines default as a delay in one payment of more than 30 days. In 2010, the Company modified $3,787 in troubled debt restructurings, of which $1,776 defaulted in 2010.

TDR Delinquency Status as of December 31, 2011

	Total TDR Loans	Current	Accruing 30-89 Days Past Due	90+ Days Past Due	Nonaccrual
Real estate construction	$ 3,292	$ 1,611	$ ---	$ ---	$ 1,681
Consumer real estate	471	156	---	---	315
Commercial real estate	3,466	1,922	---	---	1,544
Commercial non real estate	265	67	---	---	198
Public sector and IDA	---	---	---	---	---
Consumer non real estate	68	---	---	---	68
Total TDR Loans	$ 7,562	$ 3,756	$ ---	$ ---	$ 3,806

TDR Delinquency Status as of December 31, 2010

	Total TDR Loans	Current	Accruing 30-89 Days Past Due	90+ Days Past Due	Nonaccrual
Real estate construction	$ 2,185	$ ---	$ ---	$ ---	$ 2,185
Consumer real estate	---	---	---	---	---
Commercial real estate	4,048	350	---	---	3,698
Commercial non real estate	250	---	---	---	250
Public sector and IDA	---	---	---	---	---
Consumer non real estate	---	---		---	---
Total TDR Loans	$ 6,483	$ 350	$ ---	$ ---	$ 6,133

At December 31, 2010, the Company's restructured loans totaled $6,483, including $2,185 in real estate construction, $4,049 in commercial real estate, and $249 in commercial restructured loans. The increase in TDR loans stems from the ongoing negative economic environment and from recent accounting guidance. The Company expects that troubled debt restructurings will continue until the economy recovers, bringing improvement in the unemployment rate and the depressed real estate market.

Summary of Loan Loss Experience

A. Analysis of the Allowance for Loan Losses

The following tabulation shows average loan balances at the end of each period; changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category; and additions to the allowance which have been charged to operating expense:

	December 31,				
	2011	2010	2009	2008	2007
Average net loans outstanding	$ 588,439	$ 586,133	$ 579,581	$ 538,868	$ 505,070
Balance at beginning of year	7,664	6,926	5,858	5,219	5,157
Charge-offs:					
Real estate construction	444	---	---	---	64
Consumer real estate	584	475	181	35	66
Commercial real estate	320	1,050	---	82	---
Commercial non real estate	990	919	83	64	---
Public Sector and IDA	---	---	---	---	---
Consumer non real estate	290	366	383	430	341
Total loans charged off	2,628	2,810	647	611	471
Recoveries:					
Real estate construction	---	---	---	---	---
Consumer real estate	16	10	16	2	2
Commercial real estate	---	61	---	28	---
Commercial non real estate	---	1	3	9	18
Public Sector and IDA	---	---	---	---	---
Consumer non real estate	67	67	62	92	90
Total recoveries	83	139	81	131	110
Net loans charged off	2,545	2,671	566	480	361
Additions charged to operations	2,949	3,409	1,634	1,119	423
Balance at end of year	$ 8,068	$ 7,664	$ 6,926	$ 5,858	$ 5,219
Net charge-offs to average net loans outstanding	0.43 %	0.46 %	0.10 %	0.09 %	0.07 %

The Company charges off commercial real estate loans at the time that a loss is confirmed. When delinquency status or other information indicates that the borrower will not repay the loan, the Company considers collateral value based upon a current appraisal. Any loan amount in excess of collateral value is charged off and the collateral is taken into other real estate owned.

Factors influencing management's judgment in determining the amount of the loan loss provision charged to operating expense include: the quality of the loan portfolio as determined by management, the historical loan loss experience, diversification as to type of loans in the portfolio, the amount of secured as compared with unsecured loans and the value of underlying collateral, banking industry standards and averages, and general economic conditions.

B. Allocation of the Allowance for Loan Losses

The allowance for loan losses has been allocated according to the amount deemed necessary to provide for anticipated losses within the categories of loans for the years indicated as follows:

	December 31,									
	2011		2010		2009		2008		2007	
	Allowance Amount	Percent of Loans in Each Category to Total Loans	Allowance Amount	Percent of Loans in Each Category to Total Loans	Allowance Amount	Percent of Loans in Each Category to Total Loans	Allowance Amount	Percent of Loans in Each Category to Total Loans	Allowance Amount	Percent of Loans in Each Category to Total Loans
Real estate construction	$ 1,079	8.23%	$1,087	8.00%	$1,917	7.57%	$ 468	10.54%	$ 411	8.90%
Consumer real estate	1,245	25.49%	1,052	26.57%	330	26.12%	874	26.44%	404	28.23%
Commercial real estate	3,515	51.44%	3,461	50.78%	2,654	49.61%	2,566	48.12%	1,842	46.75%
Commercial non real estate	1,473	6.59%	1,089	6.50%	1,148	7.01%	1,035	6.41%	891	6.31%
Public sector and IDA	232	2.64%	259	2.17%	84	3.25%	93	2.00%	47	2.11%
Consumer non real estate	403	5.61%	587	5.98%	507	6.44%	700	6.49%	1,476	7.70%
Unallocated	121		129		286		122		148	
	$ 8,068	100.00%	$7,664	100.00%	$6,926	100.00%	$5,858	100.00%	$5,219	100.00%

An analysis of the allowance for loan losses by impairment basis follows:

	December 31,		
	2011	2010	2009
Impaired loans	$ 12,596	$ 8,791	$ 7,680
Allowance related to impaired loans	1,123	1,200	2,495
Allowance to impaired loans	8.92 %	13.65 %	32.49 %
Non-impaired loans	575,874	567,652	582,267
Allowance related to non-impaired loans	6,945	6,464	4,431
Allowance to non-impaired loans	1.21 %	1.14 %	0.76 %
Total loans, net of unearned income and deferred fees	588,470	576,443	589,947
Total allowance for loan losses	8,068	7,664	6,926
Total allowance for total loans	1.37 %	1.33 %	1.17 %

The allowance percentage for impaired loans was 8.92%, 13.65% and 32.49% as of December 31, 2011, 2010 and 2009 respectively. The ratio is subject to fluctuation because impaired loans are individually evaluated. The amount of the individual impaired loan balances that exceeds the fair value is accrued in the allowance for loan losses.

The allowance percentage for non-impaired loans was 1.21%, 1.14% and 0.76% as of December 31, 2011, 2010 and 2009 respectively. The allowance for non-impaired loans is determined by applying historical charge-off percentages, as well as additional accruals for internal and external credit risk factors to groups of non-impaired loans. The ratio increased from prior years because of increased historical charge-off percentages applied by the 2011 calculation and higher risk indications from other factors. The increase in the ratio for non-impaired loans directed the increase in the ratio of total allowance to total loans.

Securities

The fair value of securities available for sale was $174,918, a decrease of $9,989 or 5.40% from December 31, 2010. The amortized cost of securities held to maturity was $143,995 at December 31, 2011 and $131,000 at December 31, 2010, an increase of $12,995 or 9.92%. Both categories of securities increased in 2011, as liquidity from deposit growth outpaced loan opportunities. The Company elected to designate a greater portion of new securities as available for sale instead of held to maturity.

Additional information about securities available for sale and securities held to maturity can be found in Note 3 of the Notes to Consolidated Financial Statements.

The financial markets have experienced increased volatility and increased risk during the economic downturn. The risk in financial markets affects the Company in the same way that it affects other institutional and individual investors. The Company's investment portfolio includes corporate bonds. If, because of economic hardship, the corporate issuers were to default, there could be a delay in the payment of interest, or there could be a loss of principal and accrued interest. To date, there have been no defaults in any of the corporate bonds held in the portfolio. The Company's investment portfolio also contains a large percentage of municipal bonds. The recession and a slow recovery may negatively impact the ability of states and municipalities to make scheduled principal and interest payments on their outstanding indebtedness. If their income from taxes and other sources declines significantly because of the recession, states and municipalities could default on their bond obligations. The risk is at this point hypothetical, because there have been no defaults among the municipal bonds in the Company's investment portfolio.

In making investment decisions, management follows internal policy guidelines that help to limit risk by specifying parameters for both security quality and industry and geographic concentrations. Management regularly monitors the quality of the investment portfolio and tracks changes in financial markets. The value of individual securities will be written down if a decline in fair value is considered to be other than temporary, given the totality of the circumstances.

Maturities and Associated Yields

The following table presents the maturities for securities available for sale and held to maturity at their carrying values as of December 31, 2011 and weighted average yield for each range of maturities.

$ in thousands, except percent data	Maturities and Yields December 31, 2011					
	< 1 Year	1-5 Years	5-10 Years	> 10 Years	None	Total
Available for Sale:						
U.S. Treasury	$ ---	$ 2,150	$ ---	$ ---	$ ---	$ 2,150
	---	3.97 %	---	---	---	3.97 %
U.S. Government agencies	1,030	2,131	8,437	84,405	---	96,003
	4.23 %	4.59 %	4.00 %	4.12 %	---	4.12 %
Mortgage-backed securities	420	2,283	1,892	3,130	---	7,725
	4.84 %	4.97 %	4.98 %	5.36 %	---	5.12 %
States and political subdivision – taxable	729	1,042	---	---	---	1,771
	4.45 %	5.11 %	---	---	---	4.84 %
States and political subdivision – nontaxable (1)	5,727	19,221	10,704	11,699	---	47,351
	4.09 %	3.87 %	3.75 %	3.92 %	---	3.88 %
Corporate	4,708	11,369	---	---	---	16,077
	5.24 %	4.68 %	---	---	---	4.84 %
Federal Home Loan Bank stock	---	---	---	---	1,574	1,574
	---	---	---	---	0.01 %	0.01 %
Federal Reserve Bank stock	---	---	---	---	92	92
	---	---	---	---	6.00 %	6.00 %
Other securities	564	---	---	---	1,611	2,175
	0.16 %	---	---	---	2.30 %	1.75 %
Total	$ 13,178	$ 38,196	$ 21,033	$ 99,234	$ 3,277	$ 174,918
	4.39 %	4.26 %	3.96 %	4.14 %	1.31 %	4.11 %
Held to Maturity:						
U.S. Government agencies	$ 1,000	$ ---	$ 4,071	$ 16,986	$ ---	$ 22,057
	5.00 %	---	4.17 %	4.08 %	---	4.14 %
Mortgage-backed securities	---	---	---	902	---	902
	---	---	---	5.62 %	---	5.62 %
States and political subdivision – taxable	---	2,000	1,016	2,025	---	5,041
	---	5.32 %	4.47 %	4.88 %	---	4.97 %

States and political subdivision – nontaxable (1)	3,814	9,105	9,066	92,355	---	114,340
	4.15 %	3.93 %	3.78 %	4.04 %	---	4.01 %
Corporate	1,000	655	---	---	---	1,655
	4.05 %	3.95 %	---	---	---	4.01 %
Total	$ 5,814	$ 11,760	$ 14,153	$ 112,268	$ ---	$ 143,995
	4.28 %	4.17 %	3.94 %	4.07 %	---	4.08 %

(1) Rates shown represent weighted average yield on a fully taxable basis.

The majority of mortgage-backed securities and collateralized mortgage obligations held at December 31, 2011 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Federal Financial Institution Examination Council's (FFIEC) high risk mortgage security test. These tests address possible fluctuations in the average life and variances caused by the change in rate times the change in volume that have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each. Except for U.S. Government securities, the Company has no securities with any issuer that exceeds 10% of stockholders' equity.

Deposits

Total deposits increased by $34,750, or 3.93%, from $884,583 at December 31, 2010 to $919,333 at December 31, 2011. Total deposits grew $32,471, or 3.81%, from $852,112 at December 31, 2009 to December 31, 2010. A portion of the increase in both 2011 and 2010 is attributable to a higher level of municipal deposits. The increases in total deposits for 2011 and 2010 were internally generated and not the result of acquisitions.

A. Average Amounts of Deposits and Average Rates Paid

Average amounts and average rates paid on deposit categories are presented below:

	Year Ended December 31,					
	2011		2010		2009	
	Average Amounts	Average Rates Paid	Average Amounts	Average Rates Paid	Average Amounts	Average Rates Paid
Noninterest-bearing demand deposits	$ 135,880	---	$ 122,817	---	$ 115,241	---
Interest-bearing demand deposits	378,971	1.08%	322,705	1.03%	282,532	1.09%
Savings deposits	58,273	0.08%	54,543	0.09%	48,992	0.11%
Time deposits	314,920	1.60%	352,888	2.20%	399,872	3.17%
Average total deposits	$ 888,044	1.22%	$ 852,953	1.53%	$ 846,637	2.16%

B. Time Deposits of $100,000 or More

The following table sets forth time certificates of deposit and other time deposits of $100,000 or more:

	December 31, 2011				
	3 Months or Less	Over 3 Months Through 6 Months	Over 6 Months Through 12 Months	Over 12 Months	Total
Total time deposits of $100,000 or more	$ 100,230	$ 15,785	$ 305	$ 11,560	$ 127,880

Derivatives and Market Risk Exposures

The Company is not a party to derivative financial instruments with off-balance sheet risks such as futures, forwards, swaps, and options. The Company is a party to financial instruments with off-balance sheet risks such as commitments to extend credit, standby letters of credit, and recourse obligations in the normal course of business to meet the financing needs of its customers. See Note 14, of Notes to Consolidated Financial Statements for additional information relating to financial instruments with off-balance sheet risk. Management does not plan any future involvement in high risk derivative products. The Company has investments in mortgage-backed securities, principally GNMA's and FNMA's, with a fair value of approximately $8,722. See Note 3 of Notes to Consolidated Financial Statements for additional information relating to securities.

The Company's securities and loans are subject to credit and interest rate risk, and its deposits are subject to interest rate risk. Management considers credit risk when a loan is granted and monitors credit risk after the loan is granted. The Company maintains an allowance for loan losses to absorb losses in the collection of its loans. See Note 5 of

Notes to Consolidated Financial Statements for information relating to the allowance for loan losses. See Note 15 of Notes to Consolidated Financial Statements for information relating to concentrations of credit risk. The Company has an asset/liability program to manage its interest rate risk. This program provides management with information related to the rate sensitivity of certain assets and liabilities and the effect of changing rates on profitability and capital accounts.

The effects of changing interest rates are primarily managed through adjustments to the loan portfolio and deposit base, to the extent competitive factors allow. The investment portfolio is generally longer term. Adjustments for asset and liability management concerns are addressed when securities are called or mature and funds are subsequently reinvested. Historically, securities have been sold for reasons related to credit quality or regulatory limitations. Few, if any, securities available for sale have been disposed of for the express purpose of managing interest rate risk. No trading activity for this purpose is planned in the foreseeable future, though it does remain an option.

While the asset/liability planning program is designed to protect the Company over the long term, it does not provide near-term protection from interest rate shocks, as interest rate sensitive assets and liabilities do not by their nature move up or down in tandem in response to changes in the overall rate environment. The Company's profitability in the near term may be temporarily negatively affected in a period of rapidly rising or rapidly falling rates, because it takes some time for the Company to change its rates to adjust to a new interest rate environment. See Note 16 of Notes to Consolidated Financial Statements for information relating to fair value of financial instruments and comments concerning interest rate sensitivity.

Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At December 31, 2011, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

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

Regulatory capital levels determine the Company's ability to use purchased deposits and the Federal Reserve discount window. At December 31, 2011, the Company is considered well capitalized and does not have any restrictions on purchased deposits or the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At December 31, 2011, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At December 31, 2011, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At December 31, 2011, the loan to deposit ratio was 64.06%, slightly below policy levels. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

Recent Accounting Pronouncements

See Note 1 of Notes to Consolidated Financial Statements for information relating to recent accounting pronouncements.

Capital Resources

Total stockholders' equity at December 31, 2011 was $141,299, an increase of $12,112, or 9.38%, from the $129,187 at December 31, 2010. The largest component of 2011 stockholders' equity was retained earnings of $133,945, which included net income of $17,638, offset by dividends of $6,938. Exercised stock options provided $92 in 2011.

Total stockholders' equity grew by $7,111 or 5.83%, from $122,076 on December 31, 2009 to $129,187 on December 31, 2010. Earnings, net of the change in unrealized gains and losses for securities available for sale and dividends paid, accounted for most of the increase in 2010.

The Tier I and Tier II risk-based capital ratios at December 31, 2011 were 19.7% and 20.9%, respectively. Capital ratios are significantly above the regulatory minimum requirements of 4.0% for Tier I and 8.0% for Tier II. The Tier I and Tier II risk-based capital ratios at December 31, 2010 were 18.2% and 19.4%, respectively.

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Off-Balance Sheet Arrangements

The Company's off-balance sheet arrangements at December 31, 2011 are detailed in the table below.

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Commitments to extend credit	$ 130,369	$ 130,369	$ ---	$ ---	$ ---
Standby letters of credit	13,206	13,206	---	---	---
Mortgage loans with potential recourse	13,419	13,419	---	---	---
Operating leases	704	226	403	75	---
Total	$ 157,698	$ 157,220	$ 403	$ 75	$ ---

In the normal course of business the Company's banking affiliate extends lines of credit to its customers. Amounts drawn upon these lines vary at any given time depending on the business needs of the customers.
Standby letters of credit are also issued to the bank's customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation. Revenue from these letters was approximately $56 in 2011.
While it would be possible for customers to draw in full on approved lines of credit and letters of credit, historically this has not occurred. In the event of a sudden and substantial draw on these lines, the Company has its own lines of credit on which it can draw funds. A sale of loans or investments would also be an option.
The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. The mortgages originated must meet strict underwriting and documentation requirements for the sale to be completed. The Company estimates a potential loss reserve for recourse provisions. The amount is not material as of December 31, 2011. To date, no recourse provisions have been invoked.
Operating leases are for buildings used in the Company's day-to-day operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Information about market risk is set forth above in the "Interest Rate Sensitivity" and "Derivatives and Market Risk Exposure" sections of the Management's Discussion and Analysis.

Item 8. Financial Statements and Supplementary Data

Consolidated Balance Sheets	December 31,	
$ in thousands, except per share data	2011	2010
Assets		
Cash and due from banks	$ 11,897	$ 9,858
Interest-bearing deposits	98,355	69,400
Securities available for sale, at fair value	174,918	184,907
Securities held to maturity (fair value approximates $151,429 at December 31, 2011 and $129,913 at December 31, 2010)	143,995	131,000
Mortgage loans held for sale	2,623	2,460
Loans:		
Real estate construction loans	48,531	46,169
Consumer real estate loans	150,224	153,405
Commercial real estate loans	303,192	293,171
Commercial non real estate loans	38,832	37,547
Public sector and IDA loans	15,571	12,553
Consumer non real estate loans	33,072	34,543
Total loans	589, 422	577,388
Less unearned income and deferred fees	(952)	(945)
Loans, net of unearned income and deferred fees	588,470	576,443
Less allowance for loan losses	(8,068)	(7,664)
Loans, net	580,402	568,779
Premises and equipment, net	10,393	10,470
Accrued interest receivable	6,304	6,016
Other real estate owned, net	1,489	1,723
Intangible assets and goodwill	10,460	11,543
Bank-owned life insurance	19,812	17,252
Other assets	6,454	8,830
Total assets	$ 1,067,102	$ 1,022,238
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	$ 142,163	$ 131,540
Interest-bearing demand deposits	404,801	365,040
Savings deposits	61,298	55,800
Time deposits	311,071	332,203
Total deposits	919,333	884,583
Accrued interest payable	206	257
Other liabilities	6,264	8,211
Total liabilities	925,803	893,051
Commitments and contingencies	---	---
Stockholders' equity:		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	---	---
Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding, 6,939,974 shares in 2011 and 6,933,474 shares in 2010	8,675	8,667
Retained earnings	133,945	123,161
Accumulated other comprehensive (loss), net	(1,321)	(2,641)

Total stockholders' equity		141,299		129,187
Total liabilities and stockholders' equity	$	1,067,102	$	1,022,238

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income

	Years ended December 31,		
$ in thousands, except per share data	2011	2010	2009
Interest Income			
Interest and fees on loans	$ 36,514	$ 36,919	$ 37,578
Interest on interest-bearing deposits	155	128	90
Interest on securities – taxable	6,745	5,588	6,273
Interest on securities – nontaxable	6,532	6,504	6,546
Total interest income	49,946	49,139	50,487
Interest Expense			
Interest on time deposits of $100,000 or more	2,019	3,439	5,417
Interest on other deposits	7,165	7,719	10,405
Interest on borrowed funds	---	---	3
Total interest expense	9,184	11,158	15,825
Net interest income	40,762	37,981	34,662
Provision for loan losses	2,949	3,409	1,634
Net interest income after provision for loan losses	37,813	34,572	33,028
Noninterest Income			
Service charges on deposit accounts	2,617	2,858	3,314
Other service charges and fees	287	317	343
Credit card fees	3,197	2,954	2,803
Trust income	1,087	1,118	1,053
BOLI income	762	760	756
Other income	449	354	491
Realized securities gains (losses), net	11	(14)	44
Total noninterest income	8,410	8,347	8,804
Noninterest Expense			
Salaries and employee benefits	11,357	10,963	11,336
Occupancy and furniture and fixtures	1,599	1,875	1,792
Data processing and ATM	1,701	1,499	1,371
FDIC assessment	677	1,080	1,727
Credit card processing	2,485	2,300	2,121
Intangible assets amortization	1,083	1,083	1,093
Net costs of other real estate owned	518	214	393
Franchise taxes	780	963	885
Other operating expenses	3,138	3,150	3,135
Total noninterest expense	23,338	23,127	23,853
Income before income taxes	22,885	19,792	17,979
Income tax expense	5,247	4,223	3,660
Net income	$ 17,638	$ 15,569	$ 14,319
Basic net income per common share	$ 2.54	$ 2.25	$ 2.07
Fully diluted net income per common share	$ 2.54	$ 2.24	$ 2.06

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated Statements of Changes in Stockholders' Equity

$ in thousands, except per share data	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance at December 31, 2008	$ 8,662	$ 105,356	$ (3,910)		$ 110,108
Net income	---	14,319	---	$ 14,319	14,319
Other comprehensive income:					
Unrealized holding gains on available for sale securities net of deferred taxes of $1,720	---	---	---	3,193	---
Reclassification adjustment, net of income taxes of ($10)	---	---	---	(19)	---
Minimum pension liability adjustment, net of deferred taxes of $131	---	---	---	244	---
Other comprehensive income, net of tax of $1, 841	---	---	3,418	3,418	3,418
Total comprehensive income	---	---	---	$ 17,737	---
Cash dividend ($0.84 per share)	---	(5,823)	---		(5,823)
Exercise of stock options	5	49	---		54
Balance at December 31, 2009	$ 8,667	$ 113,901	$ (492)		$ 122,076
Net income	---	15,569	---	$ 15,569	15,569
Other comprehensive losses:					
Unrealized holding losses on available for sale securities net of deferred taxes of ($923)	---	---	---	(1,716)	---
Reclassification adjustment, net of income taxes of ($7)	---	---	---	(12)	---
Minimum pension liability adjustment, net of deferred taxes of ($227)	---	---	---	(421)	---
Other comprehensive losses, net of tax of ($1,157)	---	---	(2,149)	(2,149)	(2,149)
Total comprehensive income	---	---	---	$ 13,420	---
Cash dividend ($0.91 per share)	---	(6,309)	---		(6,309)
Balance at December 31, 2010	$ 8,667	$ 123,161	$ (2,641)		$ 129,187
Net income	---	17,638	---	$ 17,638	17,638
Other comprehensive income:					
Unrealized holding gains on available for sale securities net of deferred taxes of $1,468	---	---	---	2,725	---
Reclassification adjustment, net of income taxes of $9	---	---	---	17	---
Minimum pension liability adjustment, net of deferred taxes of ($766)	---	---	---	(1,422)	---

Other comprehensive income, net of tax of $711	---	---	1,320	1,320	1,320
Total comprehensive income	---	---	---	$ 18,958	---
Cash dividend ($1.00 per share)	---	(6,938)	---		(6,938)
Exercise of stock options	8	84	---		92
Balance at December 31, 2011	$ 8,675	$ 133,945	$ (1,321)		$ 141,299

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

	Years Ended December 31,		
$ in thousands	2011	2010	2009
Cash Flows from Operating Activities			
Net income	$ 17,638	$ 15,569	$ 14,319
Adjustment to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	2,949	3,409	1,634
Deferred income tax (benefit) expense	582	563	(1,057)
Depreciation of premises and equipment	799	886	906
Amortization of intangibles	1,083	1,083	1,093
Amortization of premiums and accretion of discounts, net	217	300	357
(Gains) losses on disposal of fixed assets	1	(5)	---
(Gains) losses on sale and calls of securities available for sale, net	26	(19)	(29)
(Gains) losses on calls of securities held to maturity, net	(37)	33	(15)
Losses and writedowns on other real estate owned	334	63	309
Originations of mortgage loans held for sale	(13,582)	(21,929)	(25,265)
Sales of mortgage loans held for sale	13,419	19,595	25,487
Net change in:			
Accrued interest receivable	(288)	234	(490)
Other assets	501	(858)	(3,564)
Accrued interest payable	(51)	(79)	(319)
Other liabilities	(4,135)	(280)	1,508
Net cash provided by operating activities	19,456	18,565	14,874
Cash Flows from Investing Activities			
Net change in interest-bearing deposits	(28,955)	(36,670)	(3,074)
Proceeds from repayments of mortgage-backed securities	3,823	5,817	7,119
Proceeds from calls and maturities of securities available for sale	74,961	68,565	22,446
Proceeds from calls and maturities of securities held to maturity	22,123	39,234	36,951
Purchases of securities available for sale	(64,567)	(93,862)	(45,439)
Purchases of securities held to maturity	(35,411)	(41,297)	(49,003)
Purchases of loan participations	---	(55)	(13)
Collections of loan participations	934	876	727
Loan originations and principal collections, net	(17,081)	7,820	(16,662)
Purchase of bank-owned life insurance	(1,900)	---	---
Proceeds from disposal of other real estate owned	1,391	2,393	460
Recoveries on loans charged off	84	139	81
Additions to premises and equipment	(725)	(728)	(330)
Proceeds from sale of premises and equipment	2	5	---
Net cash used in investing activities	(45,321)	(47,763)	(46,737)
Cash Flows from Financing Activities			
Net change in time deposits	(21,132)	(35,109)	(39,161)

Net change in other deposits	55,882	67,580	73,425
Net change in other borrowed funds	---	---	(54)

(continued)

Cash dividends paid	(6,938)	(6,309)	(5,823)
Stock options exercised	92	---	54
Net cash provided by financing activities	27,904	26,162	28,441
Net change in cash and due from banks	2,039	(3,036)	(3,422)
Cash and due from banks at beginning of year	9,858	12,894	16,316
Cash and due from banks at end of year	$11,897	$9,858	$12,894
Supplemental Disclosures of Cash Flow Information			
Interest paid on deposits and borrowed funds	$9,235	$11,237	$16,144
Income taxes paid	4,779	5,478	3,914
Supplemental Disclosures of Noncash Activities			
Loans charged against the allowance for loan losses	$2,628	$2,810	$647
Loans transferred to other real estate owned	1,491	2,053	911
Unrealized gains (losses) on securities available for sale	4,219	(2,658)	4,884
Minimum pension liability adjustment	(2,188)	(648)	375

The accompanying notes are an integral part of these consolidated financial statements.

Notes to Consolidated Financial Statements
$ in thousands, except share data and per share data

Note 1: Summary of Significant Accounting Policies
The consolidated financial statements include the accounts of National Bankshares, Inc. (Bankshares) and its wholly-owned subsidiaries, the National Bank of Blacksburg (NBB), and National Bankshares Financial Services, Inc. (NBFS), (the Company). All significant intercompany balances and transactions have been eliminated in consolidation.
The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The following is a summary of the more significant accounting policies.
Subsequent events have been considered through the date when the Form 10-K was issued.

Cash and Cash Equivalents
For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks.

Securities
Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.
The Company follows the accounting guidance related to recognition and presentation of other-than-temporary impairment. The guidance specifies that if (a) an entity does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that the entity will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired, unless there is a credit loss. When criteria (a) and (b) are met, the entity will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.
For equity securities, when the Company has decided to sell an impaired available-for-sale security and the Company does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

Loans Held for Sale
Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Loans held for sale are sold with the mortgage servicing rights released by the Company.

Loans
The Company, through its banking subsidiary, provides mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans, particularly commercial mortgages. The ability of the Company’s debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company’s market area.

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The Company considers multiple factors when determining whether to discontinue accrual of interest on individual loans. Generally loans are placed in nonaccrual status when collection of interest and/or full principal is considered doubtful. Interest accrual is discontinued at the time a loan is 90 days delinquent unless the credit is well secured and in the process of collection. Loans that are not restructured but that are impaired and have an associated impairment loss are placed on nonaccrual unless the borrower is paying as agreed. Loans that are modified to allow the borrower to discontinue payments of principal or interest for more than 90 days are placed on nonaccrual unless the modification provides reasonable assurance of repayment performance and collateral value supports regular underwriting requirements. If during a reasonable period of nonaccrual the restructured loan demonstrates ability to pay, the loan is returned to accrual status. Loans that finance the sale of OREO property that do not meet down payment thresholds are designated nonaccrual.

All interest accrued but not collected for loans that are placed on nonaccrual or for loans charged off is reversed against interest income. The interest received on nonaccrual loans is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are current; future payments are reasonably assured; and for loans that financed the sale of OREO property, loan-to-value thresholds are met.

A loan is considered past due when a payment of principal and/or interest is due but not paid. Credit card payments not received within 30 days after the statement date, real estate loan payments not received within the payment cycle; and all other non-real estate secured loans for which payment is not made within 30 days of the payment due date are considered 30 days past due. Management closely monitors past due loans in timeframes of 30-59 days past due, 60-89 days past due and 90 or more days past due.

Allowance for Loan Losses

The allowance for loan losses represents management’s estimate of probable losses inherent in the Company’s loan portfolio. A provision for estimated losses is charged to earnings to establish and maintain the allowance for loan losses at a level reflective of the estimated credit risk. When management determines that a loan balance or portion of a loan balance is not collectible, the loss is charged against the allowance. Subsequent recoveries, if any, are credited to the allowance.

Management evaluates the allowance each quarter through a methodology that estimates losses on individual impaired loans and evaluates the effect of numerous factors on the credit risk of groups of homogeneous loans.

Specific allowances are established for individual impaired loans based on the excess of the loan balance relative to the fair value of the loan. Impaired loans are designated as such when current information indicates that it is probable that the Company will be unable to collect principal or interest according to the contractual terms of the loan agreement. Large loans in nonaccrual status that are significantly past due, or for which a credit review identified weaknesses that indicate principal and interest will not be collected according to the loan terms as well as all loans modified in a troubled debt restructuring, are designated impaired.

Fair value of impaired loans is estimated in one of three ways. These are (1) the estimated fair value (less selling costs) of the underlying collateral, (2) the present value of the loan’s expected future cash flows, or (3) the loan’s observable market value. The amount of recorded investment (unpaid principal, accrued interest and deferred fees and costs) in an impaired loan that exceeds the fair value is accrued as estimated loss in the allowance. Impaired loans for which collection of interest or principal is in doubt are placed in nonaccrual status.

General allowances are established for non-impaired loans. Non-impaired loans are grouped into classes based on similar characteristics. Generally, any group that exceeds 5% of regulatory capital is analyzed separately. Factors considered in determining general allowances include net charge-off trends, internal risk ratings, delinquency and nonperforming rates, product mix, underwriting practices, industry trends and economic trends.

The Company’s charge-off policy meets or is more stringent than the minimum standards required by regulators. When available information confirms that a specific loan or a portion thereof is uncollectible, the amount is charged off against the allowance for loan losses. Additionally, losses on consumer loans are typically charged off no later than when the loans are 120-180 days past due, and losses on loans secured by residential real estate or by commercial real estate are charged off by the time the loans reach 180 days past due, in compliance with regulatory guidelines. Accordingly, secured loans may be charged down to the estimated value of the collateral, with previously accrued unpaid interest reversed. Subsequent charge-offs may be required as a result of changes in the market value of collateral or other repayment prospects.

Troubled Debt Restructurings (“TDRs”)

In situations where, for economic or legal reasons related to a borrower’s financial condition, management grants a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). These modified terms may include reduction of the interest rate, extension of the maturity date at an interest rate lower than the current market rate for a new loan with similar risk, forgiveness of principal or accrued interest or other actions intended to minimize the economic loss. TDR loans are measured for impairment.

Rate Lock Commitments

The Company enters into commitments to originate mortgage loans in which the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans that are intended to be sold are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best effort contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the changes in the value of the underlying assets while taking into consideration the probability that the rate lock commitments will close. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on the rate lock commitments.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, net of accumulated depreciation. Depreciation is charged to expense over the estimated useful lives of the assets on the straight-line basis. Depreciable lives include 40 years for premises, 3-10 years for furniture and equipment, and 3 years for computer software. Costs of maintenance and repairs are charged to expense as incurred and improvements are capitalized.

Other Real Estate

Real estate acquired through, or in lieu of, foreclosure is held for sale and is initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other operating expenses.

Intangible Assets and Goodwill

The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. It utilizes a two-step process for impairment testing of goodwill, which is performed annually, as well as when an event triggering impairment may have occurred. The first step tests for impairment, while the second step, if necessary, measures the impairment. The Company has elected to perform its annual analysis during the fourth quarter of each fiscal year. No indicators of impairment were identified during the years ended December 31, 2011, 2010 and 2009.

Intangible assets include customer deposit intangibles. Such intangible assets are amortized on a straight-line basis over their estimated useful lives, which are generally ten to twelve years.

Stock-Based Compensation

The Company's 1999 Stock Option Plan terminated on March 9, 2009. Incentive stock options, all of which are now vested, were granted in the early years of the Plan. There were no stock options granted in 2009. The Company recognized the cost of employment services received in exchange for awards of equity instruments based on the fair value of those awards on the date of grant. Compensation cost is recognized over the award's required service period, which is usually the vesting period.

Pension Plan

The Company recognizes the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognizes changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. The benefit obligation is the projected benefit obligation.

Income Taxes

Income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has

met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.
The Company recognizes interest and penalties on income taxes as a component of income tax expense.

Trust Assets and Income
Assets (other than cash deposits) held by the Trust Department in a fiduciary or agency capacity for customers are not included in the consolidated financial statements since such items are not assets of the Company. Trust income is recognized on the accrual basis.

Earnings Per Common Share
Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options and are determined using the treasury stock method.

The following shows the weighted average number of shares used in computing earnings per common share and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common stockholders.

	2011	2010	2009
Average number of common shares outstanding	6,936,869	6,933,474	6,932,126
Effect of dilutive options	13,994	16,462	13,404
Average number of common shares outstanding used to calculate diluted earnings per common share	6,950,863	6,949,936	6,945,530

In 2011, 2010 and 2009, stock options representing 5,750, 7,750 and 22,500 average shares respectively, were not included in the computation of diluted net income per common share because to do so would have been anti-dilutive.

Advertising
The Company practices the policy of charging advertising costs to expenses as incurred. In 2011, the Company charged $184 to expenses, and in 2010, $163 and in 2009, $179 was expensed.

Use of Estimates
In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed real estate and deferred tax assets, other-than-temporary impairments of securities and the fair value of financial instruments.
Changing economic conditions, adverse economic prospects for borrowers, as well as regulatory agency action as a result of examination, could cause NBB to recognize additions to the allowance for loan losses and may also affect the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.
Certain reclassifications have been made to prior period balances to conform to the current year provisions.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, "Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance significantly expands the existing requirements and will lead to greater transparency into an entity's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures, will be required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

In December 2010, the FASB issued ASU 2010-28, "Intangible – Goodwill and Other (Topic 350) – When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts." The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In December 2010, the FASB issued ASU 2010-29, "Business Combinations (Topic 805) – Disclosure of Supplementary Pro Forma Information for Business Combinations." The guidance requires pro forma disclosure for business combinations that occurred in the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma information should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. ASU 2010-29 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

The Securities Exchange Commission (SEC) issued Final Rule No. 33-9002, "Interactive Data to Improve Financial Reporting." The rule requires companies to submit financial statements in extensible business reporting language (XBRL) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. generally accepted accounting principles (GAAP) were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011. The Company has submitted financial statements in extensible business reporting language (XBRL) format with their SEC filings in accordance with the phased-in schedule.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB's Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2011, the FASB issued ASU 2011-01, "Receivables (Topic 310) – Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings." The amendments in this ASU temporarily delayed the effective date of the disclosures about troubled debt restructurings in Update 2010-20 for public entities. The delay was intended to allow the Board time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring was effective for interim and annual periods ending after June 15, 2011. The Company has adopted ASU 2011-01 and included the required disclosures in its consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02, "Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring." The amendments in this ASU clarify the guidance on a creditor's evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulty. The amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company has adopted ASU 2011-02 and included the required disclosures in its consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, "Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements." The amendments in this ASU remove from the assessment of effective control

(1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income." The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

In August 2011, the SEC issued Final Rule No. 33-9250, "Technical Amendments to Commission Rules and Forms related to the FASB's Accounting Standards Codification." The SEC has adopted technical amendments to various rules and forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. These revisions were necessary to conform those rules and forms to the FASB Accounting Standards Codification. The technical amendments include revision of certain rules in Regulation S-X, certain items in Regulation S-K, and various rules and forms prescribed under the Securities Act, Exchange Act and Investment Company Act. The Release was effective as of August 12, 2011. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, "Intangible – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment." The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The Company is currently assessing the impact that ASU 2011-08 will have on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company is currently assessing the impact that ASU 2011-11 will have on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." The amendments are being made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently assessing the impact that ASU 2011-12 will have on its consolidated financial statements.

Note 2: Restriction on Cash
As members of the Federal Reserve System, the Company's subsidiary bank is required to maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2011 and 2010, the aggregate amounts of daily average required balances approximated $350 in 2011 and 2010.

Note 3: Securities
The amortized cost and fair value of securities available for sale, with gross unrealized gains and losses, follows:

	December 31, 2011			
Available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ 2,010	$ 140	$ ---	$ 2,150
U.S. Government agencies and corporations	94,716	1,307	20	96,003
States and political subdivisions	47,118	2,034	30	49,122
Mortgage-backed securities	7,156	569	---	7,725
Corporate debt securities	15,852	322	97	16,077
Federal Home Loan Bank stock – restricted	1,574	---	---	1,574
Federal Reserve Bank stock – restricted	92	---	---	92
Other securities	2,330	7	162	2,175
Total securities available for sale	$ 170,848	$ 4,379	$ 309	$ 174,918

	December 31, 2010			
Available for sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ 2,015	$ 168	$ ---	$ 2,183
U.S. Government agencies and corporations	90,641	424	2,913	88,152
States and political subdivisions	60,676	1,417	411	61,682
Mortgage-backed securities	10,744	635	---	11,379
Corporate debt securities	16,902	778	---	17,680
Federal Home Loan Bank stock – restricted	1,677	---	---	1,677
Federal Reserve Bank stock – restricted	92	---	---	92
Other securities	2,308	---	246	2,062
Total securities available for sale	$ 185,055	$ 3,422	$ 3,570	$ 184,907

The amortized cost and fair value of single maturity securities available for sale at December 31, 2011, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2011.

	December 31, 2011	
	Amortized Cost	Fair Value
Due in one year or less	$ 12,986	$ 13,178
Due after one year through five years	37,091	38,196

Due after five years through ten years		19,896		21,033
Due after ten years		97,443		99,234
No maturity		3,432		3,277
	$	170,848	$	174,918

The amortized cost and fair value of securities held to maturity, with gross unrealized gains and losses, follows:

	December 31, 2011			
Held to maturity:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government agencies and corporations	$ 22,057	$ 562	$ ---	$ 22,619
States and political subdivisions	119,381	6,775	15	126,141
Mortgage-backed securities	902	94	---	996
Corporate debt securities	1,655	18	---	1,673
Total securities held to maturity	$ 143,995	$ 7,449	$ 15	$ 151,429

	December 31, 2010			
Held to maturity:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government agencies and corporations	$ 13,074	$ 310	$ 214	$ 13,170
States and political subdivisions	112,625	1,174	2,452	111,347
Mortgage-backed securities	1,142	97	---	1,239
Corporate debt securities	4,159	29	31	4,157
Total securities held to maturity	$ 131,000	$ 1,610	$ 2,697	$ 129,913

The amortized cost and fair value of single maturity securities held to maturity at December 31, 2011, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity at December 31, 2011.

	December 31, 2011	
	Amortized Cost	Fair Value
Due in one year or less	$ 5,814	$ 5,915
Due after one year through five years	11,760	12,204
Due after five years through ten years	14,153	15,126
Due after ten years	112,268	118,184
	$ 143,995	$ 151,429

Information pertaining to securities with gross unrealized losses at December 31, 2011 and 2010 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	December 31, 2011			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U. S. Government agencies and corporations	$ 6,230	$ 20	$ ---	$ ---
State and political subdivisions	3,527	19	981	26

Corporate debt securities	4,916	97	---	---
Other	---	---	142	162
Total temporarily impaired securities	$ 14,673	$ 136	$ 1,123	$ 188

	December 31, 2010							
	Less Than 12 Months				12 Months or More			
	Fair Value		Unrealized Loss		Fair Value		Unrealized Loss	
U. S. Government agencies and corporations		64,850	$	3,127	$	---	$	---
State and political subdivisions		65,640		2,605		2,528		258
Corporate debt securities		969		31		---		---
Other		---		---		247		246
Total temporarily impaired securities	$	131,459	$	5,763	$	2,775	$	504

At December 31, 2011, the Company had 19 securities with a fair value of $15,796 which had total unrealized losses of $324. The Company has made the determination that these securities are temporarily impaired at December 31, 2011 for the following reasons:

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

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

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

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

At December 31, 2010, the Company had 166 securities with a fair value of $134,234 which were temporarily impaired. The total unrealized loss on these securities, which was attributed to interest rate fluctuations, was $6,267. Because the Company had the ability and intent to hold the securities until maturity or until the cost was recovered, the losses associated with the securities were not considered other than temporary at December 31, 2010.

At December 31, 2011 and 2010, securities with a carrying value of $147,152 and $141,810, respectively, were pledged to secure trust deposits and for other purposes as required or permitted by law.

As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital and a percentage of qualifying assets. In addition, NBB is eligible to borrow from the FHLB with borrowings collateralized by qualifying assets, primarily residential mortgage loans totaling approximately $124,630, and NBB's capital stock investment in the FHLB. Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based upon the ultimate recoverability of the cost basis in the FHLB stock.

Note 4: Related Party Transactions

In the ordinary course of business, the Company, through its banking subsidiary, has granted loans to executive officers and directors of Bankshares and its subsidiaries amounting to $3,173 at December 31, 2011 and $4,025 at December 31, 2010. During the year ended December 31, 2011, total principal additions were $930 and principal payments were $1,782

Note 5: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

The allowance for loan losses methodology incorporates individual evaluation of impaired loans and collective evaluation of groups of non-impaired loans. The Company performs ongoing analysis of the loan portfolio to determine credit quality and to identify impaired loans. Determination of credit quality considers the loan's payment history, the borrower's current financial situation and value of the underlying collateral.

Impaired loans are those loans that have been modified in a troubled debt restructure ("TDR" or "restructure") as well as larger, non-homogeneous loans that are in nonaccrual status or exhibit payment history or borrower financial positions that indicate the probability that collection will not occur according to the loan's terms. Generally, impaired loans are risk rated "classified" or "special mention." Impaired loans are measured at the lower of the invested amount or the fair market value. Impaired loans with an impairment loss are designated nonaccrual. Please refer to Note 1, "Summary of Significant Accounting Policies" for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

Troubled debt restructurings impact the determination of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied by the collective evaluation methodology. Further, restructured loans are individually evaluated for impairment, with invested amounts that exceed fair value accrued in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were included in the fair value measurement. TDRs that are determined to be collateral dependent or for which decreased cash flows indicate a decline in fair value are charged down to fair value, reduced by selling costs.

The Company used a risk-based perspective to determine five major segments within the loan portfolio. Characteristics of loans within segments are further analyzed to determine sub-groups called loan classes. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. Subgroups with total balances exceeding 5% of Tier I and Tier II Capital are designated as loan classes. The collective evaluation methodology is applied to the non-impaired portfolio on a class basis.

The Company's segments consist of real estate secured consumer loans, non-real estate secured consumer loans, commercial real estate, commercial and industrial loans and construction, development and land loans. Consumer real estate is composed of loans to purchase or build a primary residence as well as equity lines secured by a primary residence. Consumer non-real estate contains credit cards, automobile and other installment loans, and deposit overdrafts. Commercial real estate is composed of all commercial loans that are secured by real estate. The commercial and industrial segment is commercial loans that are not secured by real estate. Construction, development and other land loans are composed of loans to developers of residential and commercial properties.

The categorization of loans used to determine the allowance for loan losses differs from the categorization of loans in the balance sheet and discussion of loans in the Management's Discussion and Analysis ("MD&A") section. While the categories may be similar, the balance sheet and MD&A base loan categorizations on collateral type. The allowance for loan losses methodology takes a risk-based approach to determine segments and classes for loss analysis.

The Company's segments and classes are as follows:

Consumer Real Estate	Commercial Real Estate
Equity lines	College housing
Closed-end consumer real estate	Office/Retail space
Consumer construction	Nursing homes
	Hotels
Consumer Non-Real Estate	Municipalities
Credit cards	Medical professionals
Consumer, general	Religious organizations
Consumer overdraft	Convenience stores
	Entertainment and sports
Commercial & Industrial	Nonprofits
Commercial & industrial	Restaurants
	General contractors
Construction, Development and Land	Other commercial real estate
Residential	
Commercial	

The loan portfolio is segmented based on risk characteristics. Particular characteristics associated with each segment are detailed below:

Consumer Real Estate: Consumer real estate loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

Consumer Non-Real Estate: Consumer non-real estate loans carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral, such as automobiles which may depreciate more rapidly than other assets. In addition, these loans may be unsecured. Consumer loans are more likely than real estate loans to be immediately affected in an adverse manner by job loss, divorce, illness or personal bankruptcy.

Commercial & Industrial (non-real estate): Commercial loans not secured by real estate carry risks associated with the successful operation of a business, and the repayments of these loans depend on the profitability and cash flows of the business. Additional risk relates to the value of collateral where depreciation occurs and the valuation is less precise.

Commercial Real Estate: Loans secured by commercial real estate also carry risks associated with the success of the business and ability to generate a positive cash flow sufficient to service debts. Real estate security diminishes risks only to the extent that a market exists for the subject collateral.

Construction, Development and Land: Real estate secured construction loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point, be less than the principal amount of the loan. Additional risks may occur if the general contractor, who may not be a loan customer, is unable to finish the project as planned due to financial pressures unrelated to the project.

Risk factors are analyzed for each class to estimate collective reserves. Factors include allocations for the historical charge-off percentage and changes in national and local economic and business conditions, in the nature and volume of the portfolio, in loan officers' experience and in loan quality. Increased allocations for the risk factors applied to each class are made for special mention and classified loans. The Company allocates additional reserves for "high risk" loans, determined to be junior lien mortgages, high loan-to-value loans and interest-only loans.

The Company collects and discloses data in compliance with accounting guidance in effect for the year disclosed. In December 2010, the Company adopted accounting guidance for disclosures on the allowance for loan losses. Information for periods prior to December 31, 2010 is presented according to guidance in effect for those periods, while disclosures required by the 2010 guidance are made for periods ending December 31, 2010 and forward.

An analysis of the allowance for loan losses follows:

	Years ended December 31, 2011	2010	2009
Balance at beginning of year	$ 7,664	$ 6,926	$ 5,858
Loans charged off	(2,628)	(2,810)	(647)
Recoveries of loans previously charged off	83	139	81
Provision for loan losses	2,949	3,409	1,634
Balance at end of year	$ 8,068	$ 7,664	$ 6,926

A detailed analysis showing the allowance roll-forward by portfolio segment and related loan balance by segment follows:

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2011

	Consumer Real Estate	Consumer Non-Real Estate	Commercial Real Estate	Commercial & Industrial	Construction, Development & Other Land	Unallocated	Total
Balance, December 31, 2010	$ 1,059	$ 586	$ 4,033	$ 1,108	$ 749	$ 129	$ 7,664
Charge-offs	(461)	(266)	(457)	(655)	(789)	---	(2,628)
Recoveries	14	68	---	1	---	---	83
Provision for loan losses	440	13	935	581	988	(8)	2,949
Balance, December 31, 2011	$ 1,052	$ 401	$ 4,511	$ 1,035	$ 948	$ 121	$ 8,068

Activity in the Allowance for Loan Losses by Segment for the year ended December 31, 2010