

we're better **together**



National Bankshares

Annual Report 2005

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

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| <i>United States Securities & Exchange Commission Form 10-K located in rear folder</i> | |

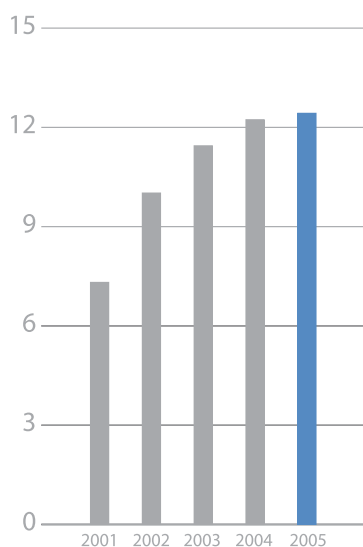
achieving results together

Financial Highlights

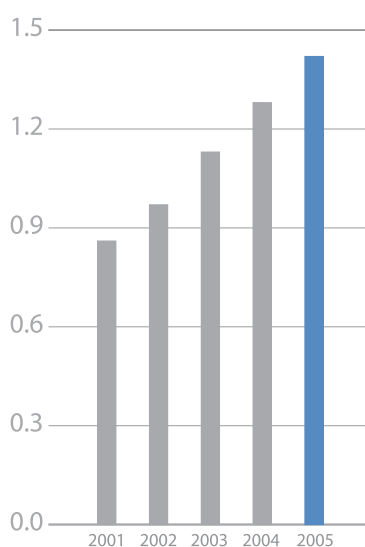
(\$ In thousands, except per share data)

| | 2005 | 2004 | 2003 | 2002 | 2001 |
|------------------------------|------------------|---------|---------|---------|---------|
| Net income | \$ 12,424 | 12,230 | 11,442 | 10,014 | 7,314 |
| Basic net income per share | 3.54 | 3.48 | 3.26 | 2.85 | 2.08 |
| Diluted net income per share | 3.52 | 3.46 | 3.24 | 2.85 | 2.08 |
| Cash dividends per share | 1.42 | 1.28 | 1.13 | 0.97 | 0.86 |
| Book value per share | 26.19 | 24.75 | 22.94 | 20.82 | 18.59 |
| Loans, net | 487,162 | 472,199 | 401,428 | 404,247 | 394,042 |
| Total securities | 272,541 | 250,708 | 230,154 | 219,294 | 191,476 |
| Total assets | 841,498 | 796,154 | 708,560 | 684,935 | 644,623 |
| Total deposits | 745,649 | 705,932 | 625,378 | 608,271 | 576,618 |
| Stockholders' equity | 91,939 | 87,088 | 80,641 | 73,101 | 65,261 |

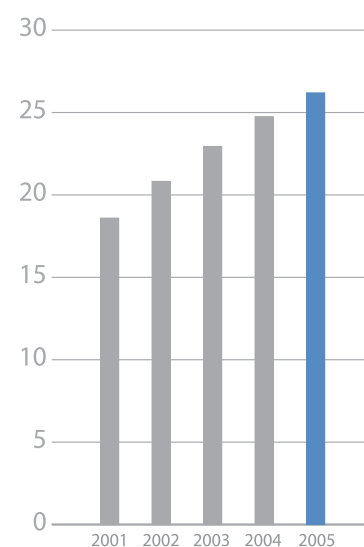
Net Income (dollars in millions)



Cash Dividends (dollars)



Book Value (dollars)

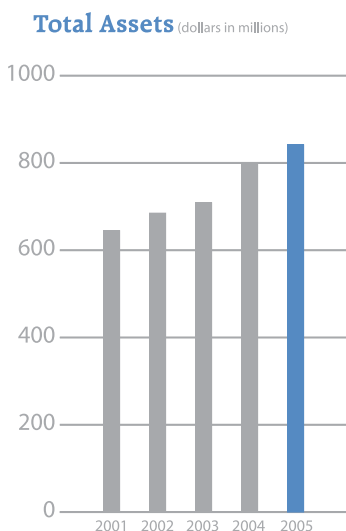


building a stronger future together

MESSAGE TO OUR STOCKHOLDERS

It is always nice to report good results to you, and there are a number of highlights in National Bankshares' performance for 2005. Net income reached a record \$12.42 million, up from \$12.23 million in 2004, which was itself a record. Following our practice of sharing the Company's success with you, National Bankshares paid \$1.42 per share in stockholder dividends last year, 11% more than in 2004. Net loans grew by 3.17%, to \$487.16 million at December 31. We are pleased with this increase in a highly competitive loan market. National Bankshares ended 2005 with total assets of almost \$841.5 million. This represents a 5.7% increase over the comparable period in the prior year.

Although the year had many highlights, 2005 was also challenging. The regular interest rate increases put into place by the Federal Reserve Bank compressed our net interest margin and impacted earnings. The Company also experienced the effects of a full year of higher noninterest expense associated with the acquisitions completed in 2004 and early 2005.



Looking ahead to the coming year, we want to make note of some important dates in our Company's long history. On May 21, National Bank (NBB) will celebrate the 115th year of its founding in Blacksburg. This year is also the 20th anniversary of National Bankshares, Inc., which was formed in 1986 as a one-bank holding company. We recently recognized the fifth birthday of National Bankshares Financial Services, Inc., our investment and insurance subsidiary. Finally, on May 31, we will mark the 10th anniversary of Bank of Tazewell County (BTC) joining the National Bankshares corporate family. In the ten years since Bank of Tazewell County has been a part of National Bankshares, we have taken many steps to capitalize on the strengths of both of our banks. Much of what takes place behind the scenes, such as accounting, audit, compliance and computer processing, has been consolidated for many years. For more than a year, the Boards of Directors of National Bankshares and of the two banks have been charting our future direction and discussing what is in the long-term best interests of customers, stockholders and employees. In December, the Directors of National Bankshares, NBB and BTC voted to merge the two banks into NBB.

A Brief History of our Company

- | | | | | | |
|---|--|--|--|---|--|
| <p>1889 CHARTER ISSUED TO BANK OF CLINCH VALLEY, FORERUNNER OF BANK OF TAZEWEEL COUNTY</p> | <p>1891 ORIGINAL CHARTER ISSUED TO BANK OF BLACKSBURG</p> | <p>1922 BANK OF BLACKSBURG RE-CHARTERED AS A NATIONAL BANK WITH ASSETS OF \$485,000</p> | <p>1929 BANK OF CLINCH VALLEY BECOMES FARMERS BANK OF CLINCH VALLEY</p> | <p>1942 THE NATIONAL BANK OF BLACKSBURG BUILT AND OWNED ITS FIRST OFFICE</p> | <p>1963 NBB MOVES TO ITS PRESENT MAIN OFFICE IN DOWNTOWN BLACKSBURG</p> |
|---|--|--|--|---|--|



BANK OF CLINCH VALLEY 1900



BANK OF BLACKSBURG 1902

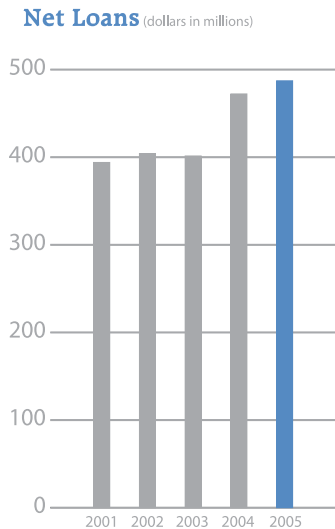


FARMERS BANK OF CLINCH VALLEY 1933



NBB MAIN OFFICE 1942

The Boards' decision to combine the two banks into one was heavily influenced by the benefits of the merger for our customers. As the banks have expanded, the two market areas have grown closer. After the merger, customers will be able to bank at any of our 26 convenient locations throughout Southwest Virginia. Businesses with multiple offices can consolidate their NBB and BTC bank accounts. Ultimately, we also expect to benefit from economies of scale. The bank merger application has been approved by regulators, employee merger teams are hard at work, and we anticipate completing the transaction during the second quarter.



The pending consolidation of the two banks has given us a good opportunity to look critically at technology, processes and procedures throughout the organization. We plan to upgrade our computer system during 2006, and we anticipate making other changes to improve our ability to serve customers well. You will even see a new bank logo this year, reflecting National Bank's connection to National Bankshares and our optimism about the future.

Over the years we've learned that solid results are the foundation for future growth, and we are confident that staying focused on our strengths is the right strategy to produce these results. We remain committed to community banking because we believe that our customers prefer to do business with financial professionals who are their neighbors and whom they know and trust. We appreciate the hard work of our Directors and employees. We are especially grateful to you for your investment, your support and your confidence in National Bankshares.

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



1964
 BANK OF TAZEWELL COUNTY RESULTS FROM THE MERGER OF BANK OF GRAHAM AND FARMERS BANK OF CLINCH VALLEY

1970
 BTC'S TAZEWELL OFFICE MOVED TO EAST MAIN STREET, SITE OF THE CURRENT BTC MAIN OFFICE

1986
 NATIONAL BANKSHARES, INC. IS FORMED AS A ONE-BANK HOLDING COMPANY

1996
 THE BANK OF TAZEWELL COUNTY PARTNERED WITH NATIONAL BANKSHARES, INC.

2001
 NATIONAL BANKSHARES FINANCIAL SERVICES, INC. IS FORMED TO OFFER INSURANCE AND INVESTMENT PRODUCTS

2005
 NATIONAL BANKSHARES, INC. EXPANDS TO 26 BANKING LOCATIONS THROUGHOUT SOUTHWEST VIRGINIA



NBB MAIN OFFICE BUILT IN 1963



TAZEWELL MAIN OFFICE 1970



HUBBARD STREET OFFICE 1999



MEMORIAL DRIVE OFFICE 2005

Consolidated Balance Sheets

| | December 31, | |
|---|--------------|---------|
| \$ In thousands, except share data. | 2005 | 2004 |
| Assets | | |
| Cash and due from banks | \$ 20,115 | 12,493 |
| Interest-bearing deposits | 10,279 | 22,463 |
| Securities available for sale, at fair value | 162,833 | 145,323 |
| Securities held to maturity (fair value approximates \$109,513 at December 31, 2005 and \$107,697 at December 31, 2004) | 109,708 | 105,385 |
| Mortgage loans held for sale | --- | 1,003 |
| Loans: | | |
| Real estate construction loans | 27,116 | 25,009 |
| Real estate mortgage loans | 117,421 | 115,388 |
| Commercial and industrial loans | 264,149 | 248,523 |
| Loans to individuals | 84,838 | 89,889 |
| Total loans | 493,524 | 478,809 |
| Less unearned income and deferred fees | (913) | (881) |
| Loans, net of unearned income and deferred fees | 492,611 | 477,928 |
| Less allowance for loan losses | (5,449) | (5,729) |
| Loans, net | 487,162 | 472,199 |
| Premises and equipment, net | 12,808 | 12,104 |
| Accrued interest receivable | 5,145 | 4,870 |
| Other real estate owned, net | 376 | 895 |
| Intangible assets and goodwill | 17,113 | 16,924 |
| Other assets | 15,959 | 2,495 |
| Total assets | \$ 841,498 | 796,154 |
| Liabilities and Stockholders' Equity | | |
| Noninterest-bearing demand deposits | \$ 112,445 | 106,189 |
| Interest-bearing demand deposits | 225,611 | 198,897 |
| Savings deposits | 54,505 | 62,817 |
| Time deposits | 353,088 | 338,029 |
| Total deposits | 745,649 | 705,932 |
| Other borrowed funds | 357 | 297 |
| Accrued interest payable | 725 | 483 |
| Other liabilities | 2,828 | 2,354 |
| Total liabilities | 749,559 | 709,066 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding | --- | --- |
| Common stock of \$2.50 par value. Authorized 10,000,000 shares; issued and outstanding, 3,509,937 in 2005 and 3,519,002 in 2004 | 8,775 | 8,797 |
| Retained earnings | 84,610 | 77,735 |
| Accumulated other comprehensive income (loss), net | (1,146) | 556 |
| Total stockholders' equity | 91,939 | 87,088 |
| Total liabilities and stockholders' equity | \$ 841,498 | 796,154 |

Consolidated Statements of Income

| \$ In thousands, except per share data. | Years ended December 31, | | |
|---|--------------------------|--------|--------|
| | 2005 | 2004 | 2003 |
| Interest Income | | | |
| Interest and fees on loans | \$ 33,234 | 29,812 | 29,798 |
| Interest on federal funds sold | --- | 5 | 16 |
| Interest on interest-bearing deposits | 508 | 196 | 230 |
| Interest on securities - taxable | 6,501 | 6,184 | 5,668 |
| Interest on securities - nontaxable | 5,137 | 5,295 | 5,369 |
| Total interest income | 45,380 | 41,492 | 41,081 |
| Interest Expense | | | |
| Interest on time deposits of \$100,000 or more | 3,942 | 3,138 | 3,016 |
| Interest on other deposits | 10,215 | 7,973 | 9,234 |
| Interest on borrowed funds | 23 | 14 | 2 |
| Total interest expense | 14,180 | 11,125 | 12,252 |
| Net interest income | 31,200 | 30,367 | 28,829 |
| Provision for loan losses | 567 | 1,189 | 1,691 |
| Net interest income after provision for loan losses | 30,633 | 29,178 | 27,138 |
| Noninterest Income | | | |
| Service charges on deposit accounts | 3,099 | 3,003 | 2,597 |
| Other service charges and fees | 298 | 252 | 267 |
| Credit card fees | 2,179 | 1,839 | 1,612 |
| Trust income | 1,398 | 1,436 | 1,132 |
| Other income | 639 | 444 | 448 |
| Realized securities gains, net | --- | 168 | 130 |
| Total noninterest income | 7,613 | 7,142 | 6,186 |
| Noninterest Expense | | | |
| Salaries and employee benefits | 11,265 | 10,498 | 9,568 |
| Occupancy and furniture and fixtures | 1,931 | 1,797 | 1,655 |
| Data processing and ATM | 1,455 | 1,302 | 1,164 |
| Credit card processing | 1,687 | 1,502 | 1,244 |
| Intangible assets and goodwill amortization | 1,117 | 967 | 954 |
| Net costs of other real estate owned | 275 | 201 | 178 |
| Other operating expenses | 4,168 | 4,069 | 3,883 |
| Total noninterest expense | 21,898 | 20,336 | 18,646 |
| Income before income tax expense | 16,348 | 15,984 | 14,678 |
| Income tax expense | 3,924 | 3,754 | 3,236 |
| Net income | \$ 12,424 | 12,230 | 11,442 |
| Basic net income per share | | | |
| | \$ 3.54 | 3.48 | 3.26 |
| Fully diluted net income per share | | | |
| | \$ 3.52 | 3.46 | 3.24 |

providing leadership **together**



National Bankshares, Inc. Board of Directors

From left: **Dr. Mary G. Miller**, President, Interactive Design and Development, Inc.; **Dr. Jeffrey R. Stewart**, Educational Consultant; **James G. Rakes**, Chairman, President and Chief Executive Officer, National Bankshares, Inc., Chairman, President and Chief Executive Officer, The National Bank, Chairman, President and Treasurer, National Bankshares Financial Services, Inc.; **Paul A. Duncan**, President, Holiday Motor Corp.; **Dr. Jack M. Lewis**, President, New River Valley Community College; **Jack H. Harry**, President, Harry Enterprises, Inc.; **L. Allen Bowman**, Vice-Chairman of the Board, Retired; **William A. Peery**, President, Cargo Oil Co., Inc.; **Dr. James M. Shuler**, Delegate, Virginia House of Delegates.



The National Bank Board of Directors

From left: **Dr. James M. Shuler**, Delegate, Virginia House of Delegates; **Lawrence J. Ball**, Vice President and General Manager, Moog Components Group; **James G. Rakes**, Chairman, President and Chief Executive Officer, National Bankshares, Inc., Chairman, President and Chief Executive Officer, The National Bank, Chairman, President and Treasurer, National Bankshares Financial Services, Inc.; **Ellen G. Burnop**, Co-Owner, New River Office Supply; **Dr. J. Lewis Webb, Jr.**, Dentist; **F. Brad Denardo**, Executive Vice President/Chief Operating Officer, The National Bank.

Bank of Tazewell County Board of Directors

From left: **James C. Thompson**, Chairman, Thompson & Litton; **James S. Gillespie, Jr.**, President, Jim Sam Gillespie Farm; **James G. Rakes**, Chairman, President and Chief Executive Officer, National Bankshares, Inc., Chairman, President and Chief Executive Officer, The National Bank, Chairman, President and Treasurer, National Bankshares Financial Services, Inc.; **Michael E. Dye**, Pharmacist/Owner, New Graham Pharmacy; **Charles E. Green, III**, Financial Planner, AXA Advisors, L.L.C.; **Jack H. Harry**, President, Harry Enterprises, Inc.



The National Bank Advisory Boards

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

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

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

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

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

Bank Of Tazewell County Advisory Boards

Bluefield Advisory Board: Don E. Neal, Michael E. Neal, Constance M. Saunders.

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

Interstate Advisory Board: Keith A. Hungate, A. Susan Keen, Steve A. Lester, II, David S. Saliba.

Corporate Information

NATIONAL BANKSHARES, INC. EXECUTIVE OFFICERS

James G. Rakes, Chairman
President and Chief Executive Officer

F. Brad Denardo
Corporate Officer

J. Robert Buchanan
Treasurer

Marilyn B. Buhyoff
Secretary and Counsel

ANNUAL MEETING

The Annual Meeting of Stockholders will be held on Tuesday, April 11, 2006 at 3:00 p.m. at Custom Catering Center, 902 Patrick Henry Drive, Blacksburg, Virginia.

CORPORATE STOCK

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

FINANCIAL INFORMATION

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

| | | |
|---|----|---|
| James G. Rakes Chairman, President and Chief Executive Officer (540) 951-6300 or (800) 552-4123 jrakes@nbbank.com | or | J. Robert Buchanan Treasurer (276) 979-0341 or (800) 914-0516 bbuchanan@nbbank.com |
|---|----|---|

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

STOCKHOLDER SERVICES AND STOCK TRANSFER AGENT

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

| | | |
|--|----|---|
| Marilyn B. Buhyoff Secretary and Counsel (540) 951-6300 or (800) 552-4123 mbuhyoff@nbbank.com | or | Registrar and Transfer Company 10 Commerce Drive Crawford, NJ 07016-3572 (800) 368-5948 info@rtco.com |
|--|----|---|

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

CORPORATE OFFICE

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NATIONAL BANKSHARES LOCATIONS

