

AMERICAN NATIONAL BANKSHARES INC
Form 10-K
March 16, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

Commission file number 0-12820

AMERICAN NATIONAL BANKSHARES INC.
(Exact name of registrant as specified in its charter)

| | |
|--|--------------------------------------|
| Virginia | 54-1284688 |
| (State of incorporation) | (I.R.S. Employer Identification No.) |
| 628 Main Street, Danville, VA | 24541 |
| (Address of principal executive offices) | (Zip Code) |

434-792-5111

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Exchange on Which Registered |
|-----------------------------|--|
| Common Stock, \$1 par value | The Nasdaq Stock Market LLC (Nasdaq Global Select Market) |

Securities registered pursuant to section 12(g) of the Act: None

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

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

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

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

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant at June 30, 2008, based on the closing price, was \$95,898,967.

The number of shares of the registrant's common stock outstanding on March 13, 2009 was 6,079,161.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on May 19, 2009, are incorporated by reference in Part III of this report.

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*Certain information required by Item 10 is incorporated herein by reference to the information that appears under the headings “Election of Directors,” “Election of Directors – Board Members Serving on Other Publicly Traded Company Boards of Directors,” “Election of Directors – Board of Directors and Committees - The Audit and Compliance Committee,” “Section 16(a) Beneficial Ownership Reporting Compliance,” “Report of the Audit and Compliance Committee,” and “Code of Conduct” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders. The information required by Item 401 of regulation S-K on executive officers is disclosed herein.

The information required by Item 11 is incorporated herein by reference to the information that appears under the headings “Compensation Discussion and Analysis,” “Compensation Committee Interlocks and Insider Participation,” and “Compensation Committee Report” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders.

The information required by Item 12 is incorporated herein by reference to the information that appears under the heading “Security Ownership” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, “Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

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The information required by Item 13 is incorporated herein by reference to the information that appears under the headings “Related Party Transactions” and “Election of Directors - Board Independence” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders.

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading “Independent Public Accountants” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders.

PART I

Forward-Looking Statements

This report contains forward-looking statements with respect to the financial condition, results of operations and business of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the “Company”). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Forward-looking statements are subject to numerous assumptions, estimates, risks, and uncertainties that could cause actual conditions, events, or results to differ materially from those stated or implied by such forward-looking statements.

A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors, may affect the operations, performance, business strategy, and results of the Company. Those factors include but are not limited to the following:

- Financial market volatility including the level of interest rates could affect the values of financial instruments and the amount of net interest income earned;
- General economic or business conditions, either nationally or in the market areas in which the Company does business, may be less favorable than expected, resulting in deteriorating credit quality, reduced demand for credit, or a weakened ability to generate deposits;
- Competition among financial institutions may increase and competitors may have greater financial resources and develop products and technology that enable those competitors to compete more successfully than the Company;
- Businesses that the Company is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards;
 - The ability to retain key personnel; and
 - The failure of assumptions underlying the allowance for loan losses.

ITEM 1 – BUSINESS

American National Bankshares Inc. is a one-bank holding company organized under the laws of the Commonwealth of Virginia in 1984. On September 1, 1984, American National Bankshares Inc. acquired all of the outstanding capital stock of American National Bank and Trust Company, a national banking association chartered in 1909 under the laws of the United States. American National Bank and Trust Company is the only banking subsidiary of American National Bankshares Inc. In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “Trust”) and a wholly owned subsidiary of American National Bankshares Inc., was formed for the purpose of issuing preferred securities (the “Trust Preferred Securities”) in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation (“Community First”). In April 2006, the Company finalized the acquisition of Community First and acquired 100% of

its preferred and common stock through a merger transaction. Community First was a bank holding company headquartered in Lynchburg, Virginia, and through its subsidiary, Community First Bank, operated four banking offices serving the city of Lynchburg and Bedford, Nelson, and Amherst Counties. The Company entered into the merger agreement with Community First because it believed the merger to be consistent with its expansion strategy to target entry into strong markets that logically extend its existing footprint. The Company had previously opened a full service banking office in the Lynchburg area and was considering opening additional offices in that area.

The operations of the Company are conducted at twenty banking offices and one loan production office serving Southern and Central Virginia and the northern portion of Central North Carolina. American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-four ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking.

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Competition and Markets

Vigorous competition exists in the Company's service area. The Company competes not only with national, regional, and community banks, but also with many other types of financial institutions, including without limitation, savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies. The Company has the largest deposit market share in the City of Danville, as well as in the City of Danville and Pittsylvania County, combined.

The Southern Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Companies within these industries, especially furniture manufacturing, have also closed plants for reasons similar to those noted above. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans. Also, the current economic and credit crisis, which is resulting in rising unemployment and increasing bankruptcies, foreclosures and bank failures nationally, may further intensify the economic pressure in our markets.

Supervision and Regulation

The Company is extensively regulated under both federal and state law. The following information describes certain aspects of that regulation applicable to the Company and does not purport to be complete. Proposals to change the laws and regulations governing the banking industry are frequently raised in Congress, in state legislatures, and before the various bank regulatory agencies. The likelihood and timing of any changes and the impact such changes might have on the Company are impossible to determine with any certainty. A change in applicable laws or regulations, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material impact on the business, operations, and earnings of the Company.

American National Bankshares Inc.

American National Bankshares Inc. is qualified as a bank holding company ("BHC") within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). As a bank holding company, American National Bankshares Inc. is required to file various reports and additional information with the FRB and is also subject to examinations by the FRB.

The BHC Act prohibits, with certain exceptions, a BHC from acquiring beneficial ownership or control of more than 5% of the voting shares of any company, including a bank, without the FRB's prior approval and from engaging in any activity other than those of banking, managing or controlling banks or other subsidiaries authorized under the BHC Act, or furnishing services to or performing services for its subsidiaries. Among the permitted activities is the ownership of shares of any company the activities of which the FRB determines to be so closely related to banking or managing or controlling banks as to be proper incident thereto.

Under FRB policy, a BHC is expected to serve as a source of financial and managerial strength to its subsidiary banks and to commit resources to support those banks. This support may be required at times when the BHC may not have the resources to provide it. Under this policy, a BHC is expected to stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial adversity and to maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.

Under the Gramm-Leach-Bliley Act, a BHC may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional BHC's. In order to qualify for the election, all of the depository institution subsidiaries of the BHC must be well capitalized, well managed, and have achieved a rating of "satisfactory" or better under the Community Reinvestment Act (the "CRA"). Financial holding companies are permitted to engage in activities that are "financial in nature" or incidental or complementary thereto as determined by the FRB. The Gramm-Leach-Bliley Act identifies several activities as "financial in nature," including insurance underwriting and sales, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. American National Bankshares Inc. has not elected to become a financial holding company.

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American National Bank and Trust Company

American National Bank and Trust Company is a federally chartered national bank and is a member of the Federal Reserve System. It is subject to federal regulation by the Office of the Comptroller of the Currency (the “OCC”), the FRB, and the Federal Deposit Insurance Corporation (“FDIC”).

Depository institutions, including American National Bank and Trust Company, are subject to extensive federal and state regulations that significantly affect their business and activities. Regulatory bodies have broad authority to implement standards and initiate proceedings designed to prohibit deposit institutions from engaging in unsafe and unsound banking practices. The standards relate generally to operations and management, asset quality, interest rate exposure, and capital. The agencies are authorized to take action against institutions that fail to meet such standards.

As with other financial institutions, the earnings of American National Bank and Trust Company are affected by general economic conditions and by the monetary policies of the FRB. The FRB exerts a substantial influence on interest rates and credit conditions, primarily through open market operations in U.S. Government securities, setting the reserve requirements of member banks, and establishing the discount rate on member bank borrowings. The policies of the FRB have a direct impact on loan and deposit growth and the interest rates charged and paid thereon. They also impact the source and cost of funds and the rates of return on investments. Changes in the FRB’s monetary policies have had a significant impact on the operating results of American National Bank and Trust Company and other financial institutions and are expected to continue to do so in the future; however, the exact impact of such conditions and policies upon the future business and earnings cannot accurately be predicted.

Dividend Restrictions and Capital Requirements

For information regarding the limitation on bank dividends and risk-based capital requirements, refer to Note 18 of the consolidated financial statements. Additional information may be found in the Shareholder’s Equity section of Management’s Discussion and Analysis of Financial Condition and Results of Operations.

FDIC Insurance

American National Bank and Trust Company’s deposits are currently insured up to the following amounts per insured depositor by the Deposit Insurance Fund of the FDIC:

- \$250,000 for accounts other than retirement accounts and noninterest-bearing transaction accounts;
 - \$250,000 for retirement accounts; and
- Unlimited coverage for noninterest-bearing transaction accounts, which applies to deposits in institutions such as American National Bank and Trust Company that are participating in the FDIC’s Temporary Liquidity Guarantee Program. For FDIC coverage purposes, interest-bearing checking accounts with an interest rate of 0.50% or less are included in the definition of noninterest-bearing transaction accounts.

Effective January 1, 2010, the standard FDIC coverage limit per depositor will return to the prior amount of \$100,000 for all deposit categories except for retirement accounts, which will continue to be insured up to \$250,000 per insured depositor.

On October 14, 2008, the FDIC announced the Temporary Liquidity Guarantee Program (“TLG Program”) to strengthen confidence and encourage liquidity in the banking system. The TLG Program consists of two components: a temporary guarantee of newly-issued senior unsecured debt the (“Debt Guarantee Program”) and a temporary unlimited guarantee of funds in noninterest-bearing transaction accounts at FDIC-insured institutions the (“Transaction Account Guarantee Program”). The Company is participating in the Transaction Account Guarantee Program but is not

participating in the Debt Guarantee Program where it has the option of issuing certain non-guaranteed senior unsecured debt.

Under federal law, deposits and certain claims for administrative expenses and employee compensation against insured depository institutions are afforded a priority over other general unsecured claims against such an institution, including federal funds and letters of credit, in the liquidation or other resolution of such an institution by any receiver appointed by regulatory authorities. Such priority creditors would include the FDIC.

Under the risk-based deposit premium assessment system of the FDIC, the assessment rates for an insured depository institution vary according to the level of risk incurred in its activities. To arrive at an assessment rate for a banking institution, the FDIC places it in one of four risk categories (referred to as Risk Categories I, II, III and IV) determined by reference to its capital levels and supervisory ratings. The assessment rates in 2008 ranged, on an annual basis, from 5 to 43 basis points, depending on the insured institution's risk category as described above. Commencing in 2009, assessment rates increased by 7 basis points in each risk category for the first quarter of 2009. Further, for institutions such as American National Bank and Trust Company that have elected to provide unlimited FDIC coverage for noninterest-bearing transaction accounts, an additional assessment at the annual rate of 10 basis points is due in 2009 for the amount of balances in non-interest bearing transaction accounts that exceed the existing coverage limit of \$250,000 for deposit accounts other than retirement accounts and noninterest-bearing transaction accounts.

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Under a revised assessment schedule effective April 1, 2009, The FDIC has set new initial base assessment rates that range, on an annual basis, from 12 to 45 basis points per \$100 of assessable deposits, depending on the insured institution's risk category as described above. These initial base assessment rates are subject to possible adjustments, including (1) for all risk categories, a potential increase for unsecured liabilities and potential decrease for long-term unsecured debt and (2) for all risk categories, other than Risk Category I, a potential increase for brokered deposits.

In February 2009, The FDIC proposed that an emergency special assessment up to 20 basis points per \$100 of deposits be collected from all insured institutions in September 2009 and further proposed that additional special assessments of up to 10 basis points each be collected as considered necessary thereafter to maintain public confidence in federal deposit insurance.

The level of FDIC insurance premium assessments in 2007 and 2008 for American National Bank and Trust Company was reduced by a cumulative total of \$499,000 through application of a one-time premium assessment credit that resulted from the provisions of the Federal Deposit Insurance Reform Act of 2005.

The Federal Deposit Insurance Corporation Improvement Act

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the federal banking agencies possess broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," as defined by the law. Under regulations established by the federal banking agencies a "well capitalized" institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10%, and a leverage ratio of at least 5%, and not be subject to a capital directive order. An "adequately capitalized" institution must have a Tier 1 capital ratio of at least 4%, a total capital ratio of at least 8%, and a leverage ratio of at least 4%, or 3% in some cases. Management believes, as of December 31, 2008 and 2007, that the Company met the requirements for being classified as "well capitalized."

As required by FDICIA, the federal banking agencies also have adopted guidelines prescribing safety and soundness standards relating to, among other things, internal controls and information systems, internal audit systems, loan documentation, credit underwriting, and interest rate exposure. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the agencies adopted regulations that authorize, but do not require, an institution which has been notified that it is not in compliance with safety and soundness standard to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the prompt corrective action provisions described above.

Community Reinvestment and Consumer Protection Laws

In connection with its lending activities, the Company is subject to a number of federal laws designed to protect borrowers and promote lending to various sectors of the economy and population. These include the Equal Credit Opportunity Act, the Truth-in-Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Community Reinvestment Act.

The CRA requires the appropriate federal banking agency, in connection with its examination of a bank, to assess the bank's record in meeting the credit needs of the communities served by the bank, including low and moderate income neighborhoods. Furthermore, such assessment is also required of banks that have applied, among other things, to merge or consolidate with or acquire the assets or assume the liabilities of an insured depository institution, or to open or relocate a branch. In the case of a BHC applying for approval to acquire a bank or BHC, the record of each

subsidiary bank of the applicant BHC is subject to assessment in considering the application. Under the CRA, institutions are assigned a rating of “outstanding,” “satisfactory,” “needs to improve,” or “substantial non-compliance.” The Company was rated “outstanding” in its most recent CRA evaluation.

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Anti-Money Laundering Legislation

The Company is subject to the Bank Secrecy Act and other anti-money laundering laws and regulations, including the USA Patriot Act of 2001. Among other things, these laws and regulations require the Company to take steps to prevent the use of the Company for facilitating the flow of illegal or illicit money, to report large currency transactions, and to file suspicious activity reports. The Company is also required to carry out a comprehensive anti-money laundering compliance program. Violations can result in substantial civil and criminal sanctions. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and BHC acquisitions.

Emergency Economic Stabilization Act of 2008

In accordance with its stated purpose of restoring liquidity and stability to the financial system of the United States, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program ("TARP"), under which the United States Department of the Treasury ("UST") is authorized to purchase preferred stock from qualified financial institutions. The Company meets the requirements to be considered a qualified financial institution. Under TARP, for organizations like the Company, the federal government's purchase limitation is generally defined as 3% of risk-weighted assets, or about \$18 million for the Company. The terms of the preferred stock generally provide that:

- Cumulative dividends will be paid at a rate of 5% for the first five years and 9% thereafter;
- Any increase in the dividend rate paid on common stock during the first three years will require the consent of the UST;
 - Any repurchase of common stock will require the consent of the UST;
 - Conditions and limitations will be placed on executive compensation; and
- UST will receive warrants, with a term of 10 years, to purchase a number of shares of common stock having an aggregate market price equal to 15% of the preferred stock amount on the day of investment.

After considering the appropriateness of applying under UST's capital purchase program, the Company has elected not to participate. The Company believes it has sufficient capital to meet the growth plans and credit needs of the communities it serves without government support.

Employees

At December 31, 2008, the Company employed 258 full-time equivalent persons. The relationship with employees is considered to be good.

Internet Access to Company Documents

The Company provides access to its Securities and Exchange Commission (the "SEC") filings through a link on the Investor Relations page of the Company's website at www.amnb.com. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

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Executive Officers of the Registrant

The following lists, as of December 31, 2008, the named executive officers of the registrant, their ages, and their positions.

| Name | Age | Position |
|-----------------------|-----|---|
| Charles H. Majors | 63 | President and Chief Executive Officer of the Company. |
| Neal A. Petrovich * | 46 | Senior Vice President, Chief Financial Officer, Treasurer and Secretary of American National Bankshares Inc.; Executive Vice President, Chief Financial Officer, and Cashier of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President, Chief Financial Officer and Cashier of American National Bank and Trust Company since May 2004; prior thereto, Senior Vice President of SouthTrust Bank. |
| Jeffrey V. Haley | 48 | Senior Vice President of American National Bankshares Inc.; President of Trust and Financial Services and Executive Vice President of American National Bank and Trust Company since July 2008; prior thereto, Executive Vice President and Chief Operating Officer of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President and Chief Administrative Officer of American National Bank and Trust Company. |
| R. Helm Dobbins | 57 | Senior Vice President of American National Bankshares Inc.; Executive Vice President and Chief Credit Officer of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President and Chief Credit Officer of American National Bank and Trust Company since June 2003; Executive Vice President and Chief Credit Officer of Citizens Bank and Trust Co. from 1998 to 2003. |
| S. Cabell Dudley, Jr. | 63 | Senior Vice President of American National Bankshares Inc. since December 2008; Executive Vice President and Chief Lending Officer of American National Bank and Trust Company since July 2008; prior thereto Senior Vice President and Commercial Relationship Manager since March 2006, prior thereto Senior Vice President of Wachovia Bank. |
| T. P. Gilliam, Jr. | 54 | Senior Vice President of American National Bankshares Inc. since December 2008; Executive Vice President and Chief Administration Officer of American National Bank and Trust Company since July 2008; prior thereto Senior Vice President of American National Bank and Trust Company since February 2007; prior thereto Chief Financial Officer of RACO, Inc. from January 2006 to February 2007; prior thereto Senior Vice President, Senior Loan Officer and Chief Banking Officer of American National Bank and Trust Company. |

* Mr. Petrovich resigned from the Company in February 2009.

ITEM 1A – RISK FACTORS

The Company's business is subject to interest rate risk and variations in interest rates may negatively affect financial performance.

Changes in the interest rate environment may reduce the Company's profits. It is expected that the Company will continue to realize income from the differential or "spread" between the interest earned on loans, securities, and other interest earning assets, and interest paid on deposits, borrowings and other interest bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest earning assets and interest bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and rising interest rates generally are associated with a lower volume of loan originations. Management cannot ensure that it can minimize the Company's interest rate risk. While an increase in the general level of interest rates may increase the loan yield and the net interest margin, it may adversely affect the ability of certain borrowers with variable rate loans to pay the interest and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect the net interest spread, asset quality, loan origination volume, and overall profitability of the Company.

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The Company faces strong competition from financial services companies and other companies that offer banking services which could negatively affect the Company's business.

Increased competition may result in reduced business for the Company. Ultimately, the Company may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that the Company offers in its service area. These competitors include national, regional, and community banks. The Company also faces competition from many other types of financial institutions, including without limitation, savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies. In particular, competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs and conduct extensive promotional and advertising campaigns.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain loans and deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. If the Company is unable to attract and retain banking customers, it may be unable to continue to grow loan and deposit portfolios and its results of operations and financial condition may otherwise be adversely affected.

Changes in economic conditions could materially and negatively affect the Company's business.

The Company's business is directly impacted by factors such as economic, political, and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies, and inflation, all of which are beyond the Company's control. A deterioration in economic conditions, whether caused by national or local concerns, especially within the Company's market area, could result in the following consequences, any of which could hurt business materially: loan delinquencies may increase; problem assets and foreclosures may increase; demand for products and services may decrease; low cost or noninterest bearing deposits may decrease; and collateral for loans, especially real estate, may decline in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral associated with existing loans.

Trust and Investment Services fee revenue is largely dependent on the fair market value of assets under care and on trading volumes in the brokerage business. General economic conditions and their subsequent effect on the securities markets tend to act in correlation. When general economic conditions deteriorate, consumer and corporate confidence in securities markets erodes, and Trust and Investment Service revenues are negatively impacted as asset values and trading volumes decrease.

A downturn in the real estate market could materially and negatively affect the Company's business.

A downturn in the real estate market could negatively affect the Company's business because significant portions of its loans are secured by real estate (approximately 81% as of December 31, 2008). The ability to recover on defaulted loans by selling the real estate collateral could then be diminished and the Company would be more likely to suffer losses on defaulted loans.

Substantially all of the Company's real property collateral is located in its market area. If there is a significant decline in real estate values, especially in our market area, the collateral for loans would provide significantly less security. Real estate values could be affected by, among other things, an economic slowdown and an increase in interest rates.

The Company is dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect the Company's prospects.

The Company currently depends heavily on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company's success also depends in part on the ability to attract and retain additional qualified management personnel. Competition for such personnel is strong in the banking industry and the Company may not be successful in attracting or retaining the personnel it requires.

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The Company is subject to extensive regulation which could adversely affect its business.

The Company's operations are subject to extensive regulation by federal, state, and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of the Company's operations. Because the Company's business is highly regulated, the laws, rules, and regulations applicable to it are subject to regular change. There are currently proposed laws, rules, and regulations that, if adopted, would impact the Company's operations. There can be no assurance that these proposed laws, rules, and regulations, or any other laws, rules, or regulations, will not be adopted in the future, which could (i) make compliance much more difficult and expensive, (ii) restrict the ability to originate, broker or sell loans, or accept certain deposits, (iii) further limit or restrict the amount of commissions, interest, or other charges earned on loans originated by the Company, or (iv) otherwise adversely affect the Company's business or prospects for business.

The primary source of the Company's income from which it pays dividends is the receipt of dividends from its subsidiary bank.

The availability of dividends from the Company is limited by various statutes and regulations. It is possible, depending upon the financial condition of the subsidiary bank and other factors, that the Office of the Comptroller of the Currency could assert that payment of dividends or other payments is an unsafe or unsound practice. In the event American National Bank and Trust Company was unable to pay dividends to American National Bankshares Inc., the holding company would likely have to reduce or stop paying common stock dividends. The Company's failure to pay dividends on its common stock could have a material adverse effect on the market price of the common stock.

A limited trading market exists for the Company's common stock which could lead to price volatility.

The Company's common stock is approved for quotation on the NASDAQ Global Select Market, but the trading volume has generally been modest. The limited trading market for the common stock may cause fluctuations in the stock's market value to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market. In addition, even if a more active market in the Company's common stock develops, management cannot ensure that such a market will continue or that shareholders will be able to sell their shares.

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

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

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

The Company is exposed to operational risk.

The Company is exposed to many types of operational risks, including reputation, legal, and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Negative public opinion can result from the actual or alleged conduct in any number of activities, including lending practices, corporate governance, and acquisitions, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect the Company's ability to attract and retain customers and can expose it to litigation and regulatory action.

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Certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process its transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company may also be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

Changes in accounting standards could impact reported earnings.

From time to time there are changes in the financial accounting and reporting standards that govern the preparation of the Company's financial statements. These changes can materially impact how the Company records and reports its financial condition and results of operations. In some instances, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of prior period financial statements.

The Company's information systems may experience an interruption or breach in security.

The Company relies heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in the Company's relationship management, general ledger, deposit, loan, and other systems. While the Company has policies and procedures designed to prevent or limit the effect of such failure, interruption, or security breach, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. Any such occurrences could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the company to civil litigation and possible financial liability, any of which could have a material adverse affect on the Company's financial condition and results of operations.

Recent Negative Developments in the Financial Industry and Credit Markets May Adversely Affect the Company's Operations and Results.

Negative developments in the latter half of 2007 and during 2008 in the credit and securitization markets have resulted in uncertainty in the financial markets in general with the expectation of the general economic downturn continuing into 2009. Loan portfolio quality has deteriorated at many institutions, and the Company also has experienced some deterioration. In addition, the value of real estate collateral supporting many home mortgages, including mortgages held by the Company, has declined and may continue to decline. Bank and bank holding company stock prices have been negatively affected, as has the ability of banks and bank holding companies to raise capital or borrow in the debt markets. As a result, the potential exists for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations. Negative developments in the financial industry and credit markets, and the impact of new legislation in response to those developments, may negatively impact the Company's operations by restricting its business operations, including its ability to originate or sell loans, and adversely impact its financial performance. In addition, these risks could affect the value of the Company's loan portfolio as well as the value of its investment portfolio, which would also negatively affect its financial performance.

ITEM 2 – PROPERTIES

As of December 31, 2008, the Company maintained twenty banking offices located in Danville, Pittsylvania County, Martinsville, Henry County, Halifax County, Lynchburg, Bedford County, Campbell County, and Nelson County in Virginia and Caswell County in North Carolina. The Company also operates a loan production office in Greensboro, North Carolina.

The principal executive offices of the Company are located at 628 Main Street in the business district of Danville, Virginia. This building, owned by the Company, was originally constructed in 1973 and has three floors totaling approximately 27,000 square feet.

The Company owns a building located at 103 Tower Drive in Danville, Virginia. This three-story facility serves as a retail banking office and houses certain of the Company's finance, administrative, and operations staff.

The Company owns an office building on 203 Ridge Street, Danville, Virginia, which is leased to Bankers Insurance, LLC. The Company has a minority ownership interest in Bankers Insurance, LLC.

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The Company purchased an office building in 2008 at 445 Mount Cross Road in Danville, Virginia where it consolidated two banking offices in January 2009 and gained additional administrative space.

The Company owns eleven other retail office locations for a total of fifteen owned buildings. There are no mortgages or liens against any of the properties owned by the Company. The Company operates twenty-four Automated Teller Machines (“ATMs”) on owned or leased facilities. The Company leases seven of the retail office locations and a storage warehouse.

ITEM 3 – LEGAL PROCEEDINGS

There are no material pending legal proceedings to which the Company is a party or to which the property of the Company is subject.

ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders of the Company through a solicitation of proxies or otherwise.

PART II

ITEM 5 – MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company’s common stock is traded on the NASDAQ Global Select Market under the symbol “AMNB.” At December 31, 2008, the Company had 1,662 shareholders of record. The following table presents the high and low closing sales prices for the Company’s common stock and dividends declared for the past two years.

Market Price of the Company’s Common Stock

| 2008 | Closing Price | | Dividends Per Share |
|----------------|---------------|----------|------------------------|
| | High | Low | |
| 4th quarter | \$ 18.25 | \$ 14.01 | \$ 0.23 |
| 3rd quarter | 18.20 | 15.80 | 0.23 |
| 2nd quarter | 22.00 | 17.45 | 0.23 |
| 1st quarter | 22.64 | 18.65 | 0.23 |
| | | | \$ 0.92 |

| 2007 | Closing Price | | Dividends Per Share |
|----------------|---------------|----------|------------------------|
| | High | Low | |
| 4th quarter | \$ 22.76 | \$ 19.40 | \$ 0.23 |
| 3rd quarter | 22.96 | 20.50 | 0.23 |

| | | | |
|----------------|-------|-------|---------|
| 2nd quarter | 23.08 | 22.15 | 0.23 |
| 1st quarter | 23.68 | 22.02 | 0.22 |
| | | | \$ 0.91 |

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The table below presents share repurchase activity during the quarter ended December 31, 2008.

| | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Maximum Number of Shares That May Yet Be Purchased Under the Program |
|------------------------|---|------------------------------------|---|--|
| October 1-31, 2008 | 4,500 | \$ 16.03 | 4,500 | 92,350 |
| November 1-30, 2008 | 1,100 | 17.07 | 1,100 | 91,250 |
| December 1-31, 2008 | 1,500 | 17.05 | 1,500 | 89,750 |
| | 7,100 | \$ 16.40 | 7,100 | |

Stock Compensation Plans

The Company maintains the 2008 Stock Incentive Plan (“2008 Plan”), which is designed to attract and retain qualified personnel in key positions, provide employees with a proprietary interest in the Company as an incentive to contribute to the success of the Company, and reward employees for outstanding performance and the attainment of targeted goals. The 2008 Plan was adopted by the Board of Directors of the Company on February 19, 2008 and approved by the stockholders on April 22, 2008 at the Company’s 2008 Annual Meeting. The 2008 Plan provides for the granting of restricted stock awards and incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board or a Board designated committee. The 2008 Plan authorized the issuance of up to 500,000 shares of common stock. The 2008 Plan replaced the Company’s stock option plan that was approved by the shareholders at the 1997 Annual Meeting, which plan terminated in 2006 (the “1997 Option Plan”).

The 2008 Plan is administered by a Committee of the Board of Directors of the Company comprised of independent directors. Under the 2008 Plan, the Committee determines which employees will be granted restricted stock awards and options, whether such options will be incentive or non-statutory options, the number of shares subject to each option, whether such options may be exercised by delivering other shares of common stock, and when such options become exercisable. In general, the per share exercise price of an incentive stock option must be at least equal to the fair market value of a share of common stock on the date the option is granted. Restricted stock would be granted under terms and conditions established by the Committee.

Stock options become vested and exercisable in the manner specified by the Committee. Each stock option or portion thereof shall be exercisable at any time on or after it vests and is exercisable until ten years after its date of grant. As of December 31, 2008, 159,610 shares remain exercisable under the 1997 Option Plan and 14,750 shares are exercisable under the 2008 Plan. There were 59,000 stock options awarded in 2008. All options granted in 2008 had multi-year vesting schedules to enhance employee retention.

December 31, 2008

| | Number of Shares to be Issued Upon Exercise of Outstanding Options | Weighted-Average Per Share Exercise Price of Outstanding Options | Number of Shares Remaining Available for Future Issuance Under Stock Compensation Plans |
|---|---|---|--|
| Equity compensation plans approved by shareholders | 218,610 | \$ 20.31 | 441,000 |
| Equity compensation plans not approved by shareholders | - | - | - |
| Total | 218,610 | \$ 20.31 | 441,000 |

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Comparative Stock Performance

The following graph compares the Company's cumulative total return to its shareholders with the returns of two indexes for the five-year period ended December 31, 2008. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2003. The indexes are the NASDAQ Composite Index; the SNL Bank \$500 Million-\$1Billion Index, which includes bank holding companies with assets of \$500 million to \$1 billion and is published by SNL Financial, LC.

American National Bankshares Inc.

| Index | Period Ending | | | | | |
|-----------------------------------|---------------|----------|----------|----------|----------|----------|
| | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 | 12/31/08 |
| American National Bankshares Inc. | 100.00 | 95.98 | 95.46 | 99.37 | 88.72 | 79.51 |
| NASDAQ Composite | 100.00 | 108.59 | 110.08 | 120.56 | 132.39 | 78.72 |
| SNL Bank \$500M-\$1B | 100.00 | 113.32 | 118.18 | 134.41 | 107.71 | 69.02 |

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ITEM 6 - SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the Company for the last five years:

(in thousands, except per share amounts and ratios)

| | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|------------|------------|------------|------------|------------|
| Results of Operations: | | | | | |
| Interest income | \$ 42,872 | \$ 48,597 | \$ 45,070 | \$ 32,479 | \$ 30,120 |
| Interest expense | 15,839 | 19,370 | 16,661 | 8,740 | 7,479 |
| Net interest income | 27,033 | 29,227 | 28,409 | 23,739 | 22,641 |
| Provision for loan losses | 1,620 | 403 | 58 | 465 | 3,095 |
| Noninterest income | 7,913 | 8,822 | 8,458 | 7,896 | 6,510 |
| Noninterest expense | 22,124 | 21,326 | 20,264 | 17,079 | 15,011 |
| Income before income tax provision | 11,202 | 16,320 | 16,545 | 14,091 | 11,045 |
| Income tax provision | 3,181 | 4,876 | 5,119 | 4,097 | 3,032 |
| Net income | \$ 8,021 | \$ 11,444 | \$ 11,426 | \$ 9,994 | \$ 8,013 |
| Period-end Balances: | | | | | |
| Securities | \$ 140,816 | \$ 157,149 | \$ 162,621 | \$ 165,629 | \$ 188,163 |
| Loans, net of unearned income | 571,110 | 551,391 | 542,228 | 417,087 | 407,269 |
| Deposits | 589,138 | 581,221 | 608,528 | 491,651 | 485,272 |
| Assets | 789,184 | 772,288 | 777,720 | 623,503 | 619,065 |
| Shareholders' equity | 102,300 | 101,511 | 94,992 | 73,419 | 71,000 |
| Shareholders' equity - tangible (a) | 77,757 | 76,591 | 69,695 | 73,287 | 70,516 |
| Per Share Information: | | | | | |
| Earnings - basic | \$ 1.32 | \$ 1.86 | \$ 1.91 | \$ 1.83 | \$ 1.43 |
| Earnings - diluted | 1.31 | 1.86 | 1.90 | 1.81 | 1.42 |
| Dividends | 0.92 | 0.91 | 0.87 | 0.83 | 0.79 |
| Book value | 16.81 | 16.59 | 15.42 | 13.49 | 12.86 |
| Book value - tangible (a) | 12.78 | 12.52 | 11.31 | 13.47 | 12.77 |
| Ratios: | | | | | |
| Return on average assets | 1.02% | 1.48% | 1.51% | 1.61% | 1.26% |
| Return on average shareholders' equity | 7.79 | 11.69 | 12.72 | 13.95 | 11.15 |
| Return on average tangible equity (b) | 10.60 | 16.09 | 16.60 | 14.35 | 11.72 |
| Net interest margin - taxable equivalent | 3.87 | 4.24 | 4.20 | 4.17 | 3.90 |
| Average shareholders' equity / average assets | 13.10 | 12.65 | 11.85 | 11.57 | 11.34 |

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| | | | | | |
|---|-------|-------|-------|-------|-------|
| Dividend payout ratio | 69.89 | 48.82 | 45.58 | 45.39 | 55.13 |
| Net charge-offs to average loans | 0.21 | 0.05 | 0.10 | 0.56 | 0.10 |
| Allowance for loan losses to period-end loans | 1.37 | 1.34 | 1.34 | 1.46 | 1.96 |
| Nonperforming assets to total assets | 0.91 | 0.42 | 0.45 | 0.72 | 1.35 |

(a) - Excludes goodwill and other intangible assets.

(b) - Excludes amortization expense, net of tax, of intangible assets.

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ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on significant changes in the financial condition and results of operations of the Company during the past three years. The discussion and analysis are intended to supplement and highlight information contained in the accompanying Consolidated Financial Statements and the selected financial data presented elsewhere in this Annual Report on Form 10-K. Financial institutions acquired by the Company during the past three years and accounted for as purchases are reflected in the financial position and results of operations of the Company since the date of their acquisition.

RECLASSIFICATION

In certain circumstances, reclassifications have been made to prior period information to conform to the 2008 presentation.

CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses and (2) goodwill impairment. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements.

The financial information contained within the Company's financial 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. In addition, GAAP itself may change from one previously acceptable method to another method.

Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

The allowance for loan losses is an estimate of the losses inherent in the loan portfolio at the balance sheet date. The allowance is based on two basic principles of accounting: (i) Statement of Financial Accounting Standards ("SFAS") 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows, or values observable in the secondary market, and the loan balance.

The Company's allowance for loan losses has three basic components: the formula allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change. The formula allowance uses a historical loss view as an indicator of future losses along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries; trends in volume and terms of loans; effects of changes in underwriting standards; experience of lending staff and economic conditions; and portfolio concentrations. In the formula allowance, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The adjusted loss factor is multiplied by the period-end balances for each risk-grade category. The formula allowance is calculated for a range of outcomes. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The unallocated allowance includes estimated losses whose impact on the portfolio has yet to be recognized in either the formula or specific allowance. The use of these values is inherently subjective and actual

losses could be greater or less than the estimates.

The reserve for unfunded loan commitments is an estimate of the losses inherent in off-balance-sheet loan commitments at the balance sheet date. It is calculated by multiplying an estimated loss factor by an estimated probability of funding, and then by the period-end amounts for unfunded commitments. The reserve for unfunded loan commitments is included in other liabilities.

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Goodwill Impairment

The Company tests goodwill on an annual basis or more frequently if events or circumstances indicate that there may have been impairment. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss in an amount equal to that excess. The goodwill impairment test requires management to make judgments in determining the assumptions used in the calculations. The goodwill impairment testing conducted by the Company in 2008 indicated that goodwill is not impaired and is properly recorded in the financial statements.

NON-GAAP PRESENTATIONS

The analysis of net interest income in this document is performed on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets.

EXECUTIVE OVERVIEW

American National Bankshares Inc. is the holding company of American National Bank and Trust Company, a community bank serving Southern and Central Virginia and the northern portion of Central North Carolina with twenty banking offices and a loan production office.

American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-four ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking.

Additional information is available on the Company’s website at www.amnb.com. The shares of American National Bankshares Inc. are traded on the NASDAQ Global Select Market under the symbol “AMNB.”

The Company’s mission, vision, and guiding principles are as follows:

Mission

We provide quality financial services with exceptional customer service.

Vision

We will enhance the value of our shareholders’ investment by being our communities’ preferred provider of relationship-based financial services.

Guiding Principles

To achieve our vision and carry out our mission, we:

- operate a sound, efficient, and highly profitable company,
- identify and respond to our internal and external customers’ needs and expectations in an ever changing financial services environment,
 - provide quality sales and quality service to our customers,
 - produce profitable growth,
 - provide an attractive return for our shareholders,
 - furnish positive leadership for the well-being of all communities we serve,
- continuously develop a challenging and rewarding work environment for our employees, and

- conduct our work with integrity and professionalism.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between interest income on earning assets, primarily loans and securities, and interest expense on interest bearing liabilities, primarily deposits. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income. The following discussion of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets, such as certain state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent basis. Net interest income divided by average earning assets is referred to as the net interest margin. The net interest spread represents the difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities.

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Net interest income decreased \$2,226,000, or 7.4% from 2007 to 2008, following a \$757,000, or 2.6% increase in 2007 from 2006 levels. The decrease in 2008 was primarily due to an 8.7% decline in the net interest margin from 4.24% in 2007 to 3.87% in 2008, the effect of which was partially offset by a 1.6% increase in the level of average interest earning assets. The increase in 2007 was primarily due to balance sheet growth including the acquisition of Community First Financial Corporation in April 2006. Additionally, purchase accounting adjustments from the Community First acquisition had a positive impact on net interest income in 2007. Payoffs of acquired loans accounted for under American Institute of Certified Public Accountants Statement of Position 03-3 resulted in \$571,000 of interest income in 2007. Interest income related to the valuation of other loans acquired from Community First was \$536,000 in 2008 and 2007. Similarly, interest expense related to the valuation of acquired deposits was \$0 and \$88,000 in 2008 and 2007, respectively. The net interest margin decreased from 4.24% in 2007 to 3.87% in 2008, after increasing from 4.20% in 2006, due primarily to the fact that loans, the largest component of earning assets, reprice at a much faster pace than deposits in interest bearing liabilities. During 2008, the Federal Open Market Committee of the Federal Reserve Board reduced the intended federal funds rate seven times from 4.25% to 0.25%. This had a dramatic effect on the Company's net interest margin.

To meet its funding needs for the Community First acquisition, the Company issued \$20,619,000 of Trust Preferred Securities during the second quarter of 2006. Interest expense associated with these securities was \$1,373,000 for 2008 and 2007 and \$1,007,000 for 2006.

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The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the years 2006 through 2008. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

Table 1 - Net Interest Income Analysis
(in thousands, except yields and rates)

| | Average Balance | | | Interest Income/Expense | | | Average Yield/Rate | | |
|---------------------------------------|-----------------|------------|------------|-------------------------|----------|----------|--------------------|-------|-------|
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| Loans: | | | | | | | | | |
| Commercial | \$ 91,117 | \$ 89,673 | \$ 84,676 | \$ 5,515 | \$ 6,980 | \$ 6,481 | 6.05% | 7.78% | 7.65% |
| Real Estate | 467,508 | 449,683 | 416,530 | 29,712 | 33,621 | 29,813 | 6.36 | 7.48 | 7.16 |
| Consumer | 8,774 | 10,420 | 12,287 | 795 | 975 | 1,152 | 9.06 | 9.36 | 9.38 |
| Total loans | 567,399 | 549,776 | 513,493 | 36,022 | 41,576 | 37,446 | 6.35 | 7.56 | 7.29 |
| Securities: | | | | | | | | | |
| Federal agencies | 45,660 | 68,521 | 94,589 | 2,215 | 3,032 | 3,745 | 4.85 | 4.42 | 3.96 |
| Mortgage-backed | 47,997 | 25,406 | 21,197 | 2,433 | 1,255 | 988 | 5.07 | 4.94 | 4.66 |
| State and municipal | 45,573 | 46,069 | 46,735 | 2,505 | 2,530 | 2,624 | 5.50 | 5.49 | 5.61 |
| Other | 6,141 | 7,484 | 11,059 | 277 | 438 | 621 | 4.51 | 5.85 | 5.62 |
| Total securities | 145,371 | 147,480 | 173,580 | 7,430 | 7,255 | 7,978 | 5.11 | 4.92 | 4.60 |
| Deposits in other banks | 9,239 | 13,431 | 12,922 | 301 | 679 | 620 | 3.26 | 5.06 | 4.80 |
| Total interest earning assets | 722,009 | 710,687 | 699,995 | 43,753 | 49,510 | 46,044 | 6.06 | 6.97 | 6.58 |
| Nonearning assets | 63,859 | 62,952 | 57,807 | | | | | | |
| Total assets | \$ 785,868 | \$ 773,639 | \$ 757,802 | | | | | | |
| Deposits: | | | | | | | | | |
| Demand | \$ 109,492 | \$ 107,834 | \$ 105,320 | 803 | 1,550 | 1,513 | 0.73 | 1.44 | 1.44 |
| Money market | 53,659 | 52,843 | 48,124 | 1,011 | 1,429 | 1,180 | 1.88 | 2.70 | 2.45 |
| Savings | 61,620 | 66,246 | 77,445 | 331 | 845 | 963 | 0.54 | 1.28 | 1.24 |
| Time | 258,773 | 261,286 | 255,856 | 10,135 | 11,711 | 9,693 | 3.92 | 4.48 | 3.79 |
| Total deposits | 483,544 | 488,209 | 486,745 | 12,280 | 15,535 | 13,349 | 2.54 | 3.18 | 2.74 |
| Customer repurchase agreements | | | | | | | | | |
| Customer repurchase agreements | 52,264 | 48,088 | 40,970 | 1,377 | 1,841 | 1,384 | 2.63 | 3.83 | 3.38 |
| Other short-term borrowings | 9,818 | 346 | 1,240 | 252 | 19 | 69 | 2.57 | 5.49 | 5.56 |

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| | | | | | | | | | |
|--|------------|------------|------------|-----------|-----------|-----------|-------|-------|-------|
| Long-term borrowings | 34,235 | 32,245 | 31,847 | 1,930 | 1,975 | 1,859 | 5.64 | 6.12 | 5.84 |
| Total interest bearing liabilities | 579,861 | 568,888 | 560,802 | 15,839 | 19,370 | 16,661 | 2.73 | 3.40 | 2.97 |
| Noninterest bearing demand deposits | 98,157 | 102,003 | 102,117 | | | | | | |
| Other liabilities | 4,933 | 4,894 | 5,059 | | | | | | |
| Shareholders' equity | 102,917 | 97,854 | 89,824 | | | | | | |
| Total liabilities and shareholders' equity | \$ 785,868 | \$ 773,639 | \$ 757,802 | | | | | | |
| Interest rate spread | | | | | | | 3.33% | 3.57% | 3.61% |
| Net interest margin | | | | | | | 3.87% | 4.24% | 4.20% |
| Net interest income (taxable equivalent basis) | | | | 27,914 | 30,140 | 29,383 | | | |
| Less: Taxable equivalent adjustment | | | | 881 | 913 | 974 | | | |
| Net interest income | | | | \$ 27,033 | \$ 29,227 | \$ 28,409 | | | |

Table 2 presents the dollar amount of changes in interest income and interest expense, and distinguishes between changes resulting from fluctuations in average balances of interest earning assets and interest bearing liabilities (volume), and changes resulting from fluctuations in average interest rates on such assets and liabilities (rate). Changes attributable to both volume and rate have been allocated proportionately.

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(in thousands)

| | 2008 vs. 2007 | | | 2007 vs. 2006 | | |
|-----------------------------------|------------------------|---------------------------|---------|------------------------|---------------------------|----------|
| | Increase (Decrease) | Change Attributable to | | Increase (Decrease) | Change Attributable to | |
| Interest income | | Rate | Volume | | Rate | Volume |
| Loans: | | | | | | |
| Commercial | \$ (1,465) | \$ (1,576) | \$ 111 | \$ 499 | \$ 111 | \$ 388 |
| Real Estate | (3,909) | (5,200) | 1,291 | 3,808 | 1,367 | 2,441 |
| Consumer | (180) | (30) | (150) | (177) | (2) | (175) |
| Total loans | (5,554) | (6,806) | 1,252 | 4,130 | 1,476 | 2,654 |
| Securities: | | | | | | |
| Federal agencies | (817) | 270 | (1,087) | (713) | 404 | (1,117) |
| Mortgage-backed | 1,178 | 34 | 1,144 | 267 | 62 | 205 |
| State and municipal | (25) | 2 | (27) | (94) | (57) | (37) |
| Other securities | (161) | (90) | (71) | (183) | 25 | (208) |
| Total securities | 175 | 216 | (41) | (723) | 434 | (1,157) |
| Deposits in other banks | (378) | (201) | (177) | 59 | 34 | 25 |
| Total interest income | (5,757) | (6,791) | 1,034 | 3,466 | 1,944 | 1,522 |
| Interest expense | | | | | | |
| Deposits: | | | | | | |
| Demand | (747) | (770) | 23 | 37 | 1 | 36 |
| Money market | (418) | (440) | 22 | 249 | 127 | 122 |
| Savings | (514) | (459) | (55) | (118) | 24 | (142) |
| Time | (1,576) | (1,464) | (112) | 2,018 | 1,808 | 210 |
| Total deposits | (3,255) | (3,133) | (122) | 2,186 | 1,960 | 226 |
| Customer repurchase agreements | (464) | (613) | 149 | 457 | 198 | 259 |
| Other borrowings | 188 | (427) | 615 | 66 | 95 | (29) |
| Total interest expense | (3,531) | (4,173) | 642 | 2,709 | 2,253 | 456 |
| Net interest income | \$ (2,226) | \$ (2,618) | \$ 392 | \$ 757 | \$ (309) | \$ 1,066 |

Noninterest Income

Noninterest income is generated from a variety of sources, including fee-based deposit services, trust and investment services, mortgage banking, and retail brokerage. Noninterest income also includes net gains or losses on sales, calls, or impairment of investment securities.

Noninterest income was \$7,913,000 in 2008, down 10.3% from 2007, resulting primarily from decreases in trust fees, service charges on deposit accounts, mortgage banking income, brokerage, income from investment in insurance companies, and losses of \$450,000 on securities.

Noninterest income was \$8,822,000 in 2007, up 4.3% over 2006. Increases in trust fees, mortgage banking income, brokerage, and other fee income were partially offset by decreases in deposit account service charges and by a \$362,000 impairment charge on securities.

Fees from the management of trusts, estates, and asset management accounts totaled \$3,467,000 in 2008, down from \$3,578,000 in 2007 and up from \$3,374,000 in 2006. These changes were due primarily to market value decline or appreciation in the securities markets as a substantial proportion of these fees are earned as a percentage of the account balances.

Service charges on deposits accounts decreased 8.2% in 2008 and 4.6% in 2007, primarily due to reduced customer overdraft activity.

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Other fees and commissions primarily include income generated from the Company's debit card, ATM, safe deposit box, merchant credit card, and wire transfer services. Insurance commission revenue is also included in this category. Other fees and commissions were \$ 857,000 in 2008, \$786,000 in 2007, and \$744,000 in 2006. The increase in both 2008 and 2007 is primarily the result of growth in debit card revenue due to increased customer debit card activity.

Mortgage banking income represents fees from originating and selling residential mortgage loans. Mortgage banking income was \$788,000 in 2008, \$954,000 in 2007, and \$709,000 in 2006. Changes in interest rates directly impact the volume of mortgage activity and, in turn, the amount of mortgage banking fee income earned.

Securities are sold from time to time for balance sheet management purposes or because an investment no longer meets the Company's policy requirements. Net losses on sales or calls of securities were \$450,000 in 2008, resulting from \$51,000 in gains and \$501,000 in losses. Net gains on sales or calls of securities were \$135,000 in 2007 and \$62,000 in 2006.

During 2008, the Company sold all remaining shares it held in Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC") preferred stock, resulting in a loss of \$501,000 which is referenced above. In December 2007, the Company recorded a \$362,000 impairment charge relating to its holdings of FHLMC and FNMA preferred stock. The impairment charges are recorded as a reduction of noninterest income.

Other noninterest income was \$496,000 in 2008, \$650,000 in 2007, and \$496,000 in 2006. The 2008 decline resulted primarily from a \$138,000 reduction in revenue from the Company's investments in Bankers Insurance, LLC and Virginia Title Center, LLC. The 2007 increase was largely the result of increased dividend revenue from the Company's two insurance company investments. Additionally, a full year of revenue from the Company's bank owned life insurance ("BOLI") policies increased this income category by \$34,000 in 2007.

Table 3 - Noninterest income
(in thousands)

| | Years Ended December 31, | | |
|-------------------------------------|--------------------------|----------|----------|
| | 2008 | 2007 | 2006 |
| Trust fees | \$ 3,467 | \$ 3,578 | \$ 3,374 |
| Service charges on deposit accounts | 2,324 | 2,531 | 2,654 |
| Other fees and commissions | 857 | 786 | 744 |
| Mortgage banking income | 788 | 954 | 709 |
| Brokerage fees | 431 | 550 | 419 |
| Securities gains (losses), net | (450) | 135 | 62 |
| Impairment of securities | - | (362) | - |
| Investment in insurance companies | 142 | 280 | 220 |
| | 136 | 134 | 100 |

| | | | |
|---------------------------|----------|----------|----------|
| Bank owned life insurance | | | |
| Check order charges | 129 | 127 | 113 |
| Other | 89 | 109 | 63 |
| | \$ 7,913 | \$ 8,822 | \$ 8,458 |

Noninterest Expense

Noninterest expense consists primarily of personnel, occupancy, equipment, and other expenses. Noninterest expense was \$22,124,000 in 2008, up 3.7% over 2007, due primarily to increased health insurance costs and provision for unfunded lending commitments. Noninterest expense was \$21,326,000 in 2007, up 5.2% over 2006, due primarily to increased staff levels and a full year of expenses associated with the April 2006 Community First acquisition.

Personnel expenses comprise over half of the Company's noninterest expense. Combined salary and benefits expense increased 2.9% in 2008 when compared to 2007. Employee insurance costs represent 73% of the 2008 increase. Personnel expenses increased 3.4% in 2007 when compared to 2006. Combined higher staff levels and a full year of the expenses associated with the Community First acquisition were partially offset by a reduction in profit sharing and incentive compensation expense. Profit sharing and incentive expense was \$0 in 2008, \$287,000 in 2007, and \$867,000 in 2006.

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Occupancy and equipment expense increased from \$3,527,000 in 2007 to \$3,701,000 in 2008, an increase of 4.9%. The increase was primarily due to increases in software maintenance and depreciation. Occupancy and equipment expense increased from \$2,977,000 in 2006 to \$3,527,000 in 2007, an increase of 18.5%. The increase was due in large part to a full year of expenses associated with the Community First acquisition, increased building maintenance costs, the expenses of two new branch offices, and costs related to new technology for check processing and network security.

Bank franchise tax expense was \$694,000 in 2008, compared with \$663,000 in 2007 and \$651,000 in 2006. This expense is based in large part on the level of shareholders' equity.

Core deposit intangible expense was \$377,000 in 2008 and 2007, and \$414,000 in 2006. The 2008 and 2007 expense consists entirely of amortization of the core deposit intangible asset from the Community First acquisition; beginning April 2006, this asset is being amortized on a straight-line basis over ninety-nine months. Core deposit intangible expense in 2006 also includes amortization of the core deposit intangible asset arising from a 1996 branch purchase.

Other noninterest expense consists of a variety of expenses including those related to professional services, advertising and marketing, FDIC assessment, telephone systems, ATM and Internet banking services, trust services, supplies, Federal Reserve services, and provision for unfunded lending commitments. Other noninterest expense totaled \$4,559,000 in 2008, \$4,322,000 in 2007, and \$4,196,000 in 2006. Other noninterest expense increased 5.5% in 2008, and was largely the result of an increase in the provision for unfunded lending commitments of \$297,000 over the amount in 2007. Other noninterest expense increased 3.0% in 2007, and was largely the result of higher trust service costs and a full year of expenses associated with the acquisition of Community First.

Table 4 - Noninterest expense
(in thousands)

| | Years Ended December 31, | | |
|--|--------------------------|----------|----------|
| | 2008 | 2007 | 2006 |
| Salaries | \$ 9,792 | \$ 9,688 | \$ 9,520 |
| Employee benefits | 3,001 | 2,749 | 2,506 |
| Occupancy and equipment | 3,701 | 3,527 | 2,977 |
| Bank franchise tax | 694 | 663 | 651 |
| Core deposit intangible amortization | 377 | 377 | 414 |
| Telephone | 433 | 395 | 361 |
| Provision for unfunded lending commitments | 324 | 27 | 123 |
| Stationery and printing supplies | 306 | 335 | 395 |
| Trust services contracted | 278 | 237 | 187 |
| Postage | 245 | 273 | 240 |
| ATM and VISA network fees | 243 | 329 | 303 |
| Director fees | 225 | 205 | 194 |
| | 203 | 300 | 267 |

| | | | |
|---------------------------|-----------|-----------|-----------|
| Advertising and marketing | | | |
| Legal | 194 | 119 | 148 |
| Internet banking fees | 193 | 194 | 173 |
| FDIC assessment | 180 | 87 | 84 |
| Regulatory assessments | 179 | 187 | 170 |
| Automobile | 174 | 147 | 103 |
| Auditing | 173 | 168 | 142 |
| Loan expenses | 140 | 108 | 67 |
| Contributions | 118 | 120 | 138 |
| Dues and subscriptions | 113 | 106 | 108 |
| Courier service | 107 | 106 | 97 |
| Correspondent bank fees | 86 | 161 | 161 |
| Other | 645 | 718 | 735 |
| | \$ 22,124 | \$ 21,326 | \$ 20,264 |

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Income Taxes

Income taxes on 2008 earnings amounted to \$3,181,000, resulting in an effective tax rate of 28.4%, compared to 29.9% in 2007 and 30.9% in 2006. The Company was subject to a statutory, blended, Federal tax rate of 34.1% in 2008, 34.4% in 2007, and 34.4% in 2006. The major difference between the statutory rate and the effective rate results from income that is not taxable for Federal income tax purposes. The primary non-taxable income is that of state and municipal securities and industrial revenue bonds or loans.

Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The most significant effect of inflation is on noninterest expenses that tend to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Company has the ability to react to those changes and measure and monitor its interest rate and liquidity risk.

Market Risk Management

Effectively managing market risk is essential to achieving the Company's financial objectives. Market risk reflects the risk of economic loss resulting from changes in interest rates and market prices. The Company is generally not subject to currency exchange risk or commodity price risk. The Company's primary market risk exposure is interest rate risk; however, market risk also includes liquidity risk. Both are discussed below.

Interest Rate Risk Management

Interest rate risk and its impact on net interest income is a primary market risk exposure. The Company manages its exposure to fluctuations in interest rates through policies approved by its Asset/Liability Investment Committee ("ALCO") and Board of Directors, both of which receive and review periodic reports of the Company's interest rate risk position.

The Company uses simulation analysis to measure the sensitivity of projected earnings to changes in interest rates. Simulation takes into account current balance sheet volumes and the scheduled repricing dates and maturities of assets and liabilities. It incorporates numerous assumptions including growth, changes in the mix of assets and liabilities, prepayments, and average rates earned and paid. Based on this information, management uses the model to project net interest income under multiple interest rate scenarios.

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster or to a greater extent than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position at December 31, 2008 is asset sensitive.

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The interest rate sensitivity position at December 31, 2008 is illustrated in the following table. The carrying amounts of assets and liabilities are presented in the periods they are expected to reprice or mature.

Table 5 - Interest Rate Sensitivity Gap Analysis
December 31, 2008
(dollars in thousands)

| | Within 1 Year | > 1 Year to 3 Years | > 3 Year to 5 Years | > 5 Years | Total |
|--|------------------|---------------------------|------------------------------|-----------|----------|
| Interest sensitive assets: | | | | | |
| Interest bearing deposits with other banks | \$ 1,112 | \$ - | \$ 8,000 | \$ - | \$ 9,112 |
| Securities | 15,116 | 41,839 | 16,802 | 67,059 | 140,816 |
| Loans (1) | 347,594 | 99,879 | 73,248 | 52,153 | 572,874 |
| Total interest sensitive assets | 363,822 | 141,718 | 98,050 | 119,212 | 722,802 |
| Interest sensitive liabilities: | | | | | |
| Checking and savings deposits | 175,756 | - | - | - | 175,756 |
| Money market deposits | 56,615 | - | - | - | 56,615 |
| Time deposits | 181,352 | 49,873 | 29,839 | - | 261,064 |
| Customer repurchase agreements | 51,741 | - | - | - | 51,741 |
| Federal Home Loan Bank advances | 7,850 | 5,000 | 8,000 | 787 | 21,637 |
| Trust preferred capital notes | - | - | 20,619 | - | 20,619 |

| | | | | | |
|--|--------------|-------------|-----------|------------|------------|
| Total interest sensitive liabilities | 473,314 | 54,873 | 58,458 | 787 | 587,432 |
| Interest sensitivity gap | \$ (109,492) | \$ 86,845 | \$ 39,592 | \$ 118,425 | \$ 135,370 |
| Cumulative interest sensitivity gap | \$ (109,492) | \$ (22,647) | \$ 16,945 | \$ 135,370 | |
| Percentage cumulative gap to total interest sensitive assets | (15.1) % | (3.1) % | 2.3% | 18.7% | |

(1) Loans include loans held for sale and are net of unearned income.

Table 6 shows the estimated impact of changes in interest rates on net interest income as of December 31, 2008, assuming gradual and parallel changes in interest rates, and consistent levels of assets and liabilities. Net interest income for the following twelve months is projected to increase when interest rates are higher than current rates. Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates.

Table 6 - Estimated Changes in Net Interest Income
(dollars in thousands)

| Change in Interest Rates | December 31, 2008 | |
|--------------------------|---|---------|
| | Changes in Net interest Income (1) Amount | Percent |
| Up 3.0% | \$ 2,460 | 9.3% |
| Up 2.0% | 2,210 | 8.3 |
| Up 1.0% | 1,443 | 5.4 |
| Up 0.5% | 836 | 3.2 |
| No change | - | - |

(1) Represents the difference between estimated net interest income for the next 12 months in the new interest rate environment and the current interest rate

environment.

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Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Interest rate shifts may not be parallel.

Changes in interest rates can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Company's interest rate sensitivity position. Additionally, credit risk may rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

Liquidity Risk Management

Liquidity is the ability of the Company to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities. Liquidity management involves maintaining the Company's ability to meet the daily cash flow requirements of its customers, whether they are borrowers requiring funds to meet their credit needs or depositors desiring to withdraw funds. Additionally, the parent company requires cash for various operating needs including dividends to shareholders, stock repurchases, the servicing of debt, and the payment of general corporate expenses. The Company manages its exposure to fluctuations in interest rates through policies approved by the ALCO and Board of Directors, both of which receive periodic reports of the Company's interest rate risk position. The Company uses a simulation and budget model to assist in the management of the future liquidity needs of the Company.

Liquidity sources include cash and amounts due from banks, deposits in other banks, loan repayments, increases in deposits, lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB"), federal funds lines of credit from two correspondent banks, and maturities and sales of securities. Management believes that these sources provide sufficient and timely liquidity.

The Company has a line of credit with the FHLB, equal to 30% of the Company's assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. Borrowings under the line were \$21,637,000 at December 31, 2008 and \$16,137,000 at December 31, 2007.

The Company had fixed-rate term borrowing contracts with the FHLB as of December 31, 2008, with the following final maturities:

| Amount | Expiration Date |
|-------------|--------------------|
| \$5,000,000 | 2009 |
| 8,000,000 | 2011 |
| 787,000 | 2014 |

The Company has federal funds lines of credit established with two other banks in the amounts of \$15,000,000 and \$5,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at December 31, 2008 or 2007.

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BALANCE SHEET ANALYSIS

Securities

The securities portfolio generates income, plays a primary role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The securities portfolio consists primarily of high quality investments. Federal agency, mortgage-backed, and state and municipal securities comprise the majority of the portfolio.

During 2008, the Company sold all remaining shares it held in FNMA and FHLMC preferred stock.

The following table presents information on the amortized cost, maturities, and taxable equivalent yields of securities at the end of the last three years.

Table 7 - Securities Portfolio
(in thousands, except yields)

| | 2008 | | December 31, 2007 | | 2006 | |
|---------------------------------|------------------------------|---------------------|------------------------------|---------------------|------------------------------|---------------------|
| | Taxable Amortized Cost | Equivalent Yield | Taxable Amortized Cost | Equivalent Yield | Taxable Amortized Cost | Equivalent Yield |
| Federal Agencies: | | | | | | |
| Within 1 year | \$ 8,240 | 4.58% | \$ 4,000 | 3.46% | \$ 36,969 | 3.92% |
| 1 to 5 years | 29,719 | 4.95 | 45,170 | 4.79 | 45,432 | 4.62 |
| 5 to 10 years | 5,372 | 5.15 | 6,180 | 5.46 | 6,706 | 4.67 |
| Over 10 years | - | - | - | - | - | - |
| Total | 43,331 | 4.91 | 55,350 | 4.77 | 89,107 | 4.34 |
| Mortgage-backed: | | | | | | |
| Within 1 year | 746 | 3.91 | 108 | 3.43 | - | - |
| 1 to 5 years | 3,435 | 4.95 | 3,461 | 4.33 | 4,460 | 4.51 |
| 5 to 10 years | 12,730 | 4.81 | 14,411 | 4.85 | 8,345 | 4.83 |
| Over 10 years | 28,482 | 5.08 | 27,674 | 5.34 | 6,805 | 5.06 |
| Total | 45,393 | 4.97 | 45,654 | 5.10 | 19,610 | 4.84 |
| State and Municipal: | | | | | | |
| Within 1 year | 4,549 | 5.04 | 4,025 | 5.60 | 1,330 | 6.69 |
| 1 to 5 years | 23,127 | 4.99 | 24,443 | 4.97 | 23,036 | 5.15 |
| 5 to 10 years | 9,302 | 5.99 | 11,679 | 5.63 | 16,550 | 5.16 |
| Over 10 years | 6,615 | 6.19 | 7,878 | 5.73 | 5,179 | 6.03 |
| Total | 43,593 | 5.39 | 48,025 | 5.31 | 46,095 | 5.30 |
| Other Securities: | | | | | | |
| Within 1 year | 1,485 | 3.32 | - | - | 1,005 | 6.06 |
| 1 to 5 years | - | - | 1,485 | 3.32 | 1,485 | 3.32 |
| 5 to 10 years | - | - | - | - | - | - |

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| | | | | | | |
|-----------------|------------|-------|------------|-------|------------|-------|
| Over 10 years | 3,899 | 2.35 | 4,994 | 6.56 | 6,401 | 6.21 |
| Total | 5,384 | 2.62 | 6,479 | 5.82 | 8,891 | 5.71 |
| Total portfolio | \$ 137,701 | 4.99% | \$ 155,508 | 5.08% | \$ 163,703 | 4.74% |

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Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans increased \$17,623,000, or 3.2%, from 2007 to 2008. Average loans increased \$36,283,000, or 7.1%, from 2006 to 2007. The 2007 increase was due largely to the acquisition of Community First, which occurred in April 2006.

Period-end loans increased \$19,719,000, or 3.6%, from December 31, 2007 to December 31, 2008. The increase was primarily due to growth in commercial real estate and home equity loans.

Loans held for sale are loans originated and in process of being sold to the secondary market. These loans are sold servicing released and totaled \$1,764,000 at December 31, 2008, and \$1,368,000 at December 31, 2007.

The following table provides loan balances, percentage of portfolio (excluding loans held for sale), and the percentage change since December 31, 2007 of loans outstanding by geographic region. The loans are allocated to the region in which they were originated. In some circumstances, loans may be originated in one region for borrowers located in other regions.

Table 8 - Loans by Geographic Region

| (dollars in thousands) | December 31, 2008 | | |
|---------------------------------|-------------------|-------------------------|--|
| | Balance | Percentage of Portfolio | Percentage Change in Balance Since December 31, 2007 |
| Danville region | \$ 218,292 | 38.2% | 5.9% |
| Central region | 161,933 | 28.4 | 7.2 |
| Southside region: | | | |
| Martinsville and Henry County | 111,788 | 19.6 | 3.4 |
| Halifax and Pittsylvania County | 61,415 | 10.7 | (2.8) |
| Greensboro area | 17,682 | 3.1 | (23.3) |
| Total loans | \$ 571,110 | 100.0% | |

The Company does not participate in highly leveraged lending transactions, as defined by bank regulations, and there are no loans of this nature recorded in the loan portfolio. The Company has no foreign loans in its portfolio. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2008 or 2007, loans to lessors of nonresidential buildings represented 13.7% of total loans at December 31, 2008 and 11.0% at December 31, 2007; the lessees and lessors are engaged in a variety of

industries.

Table 9 illustrates loans by type.

Table 9 - Loans

| (in thousands) | 2008 | 2007 | December 31, 2006 | 2005 | 2004 |
|-----------------------------------|------------|------------|----------------------|------------|------------|
| Real estate: | | | | | |
| Construction and land development | \$ 63,361 | \$ 69,803 | \$ 69,404 | \$ 50,092 | \$ 34,101 |
| Commercial real estate | 207,160 | 198,332 | 186,639 | 142,968 | 147,653 |
| Residential real estate | 136,480 | 133,899 | 131,126 | 94,405 | 91,672 |
| Home equity | 57,170 | 48,313 | 52,531 | 42,178 | 42,620 |
| Total real estate | 464,171 | 450,347 | 439,700 | 329,643 | 316,046 |
| Commercial and industrial | 98,546 | 91,028 | 91,511 | 76,735 | 75,847 |
| Consumer | 8,393 | 10,016 | 11,017 | 10,709 | 15,376 |
| Total loans | \$ 571,110 | \$ 551,391 | \$ 542,228 | \$ 417,087 | \$ 407,269 |

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The following table presents the maturity schedule of selected loan types (in thousands).

Table 10 - Maturities of Selected Loan Types
December 31, 2008

| (in thousands) | Commercial and Industrial (1) | Real Estate Construction | Total |
|-------------------|--|-----------------------------|------------|
| 1 year or less | \$ 63,928 | \$ 42,949 | \$ 106,877 |
| 1 to 5 years (2) | 29,994 | 14,838 | 44,832 |
| After 5 years (2) | 4,624 | 5,574 | 10,198 |
| Total | \$ 98,546 | \$ 63,361 | \$ 161,907 |

(1) includes agricultural loans.

(2) Of the loans due after one year, \$48,578 have predetermined interest rates and \$6,452 have floating or adjustable interest rates.

Allowance for Loan Losses, Asset Quality, and Credit Risk Management

The purpose of the allowance for loan losses is to provide for probable losses in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The Company uses certain practices to manage its credit risk. These practices include (a) appropriate lending limits for loan officers, (b) a loan approval process, (c) careful underwriting of loan requests, including analysis of borrowers, collateral, and market risks, (d) regular monitoring of the portfolio, including diversification by type and geography, (e) review of loans by a Loan Review department which operates independently of loan production, (f) regular meetings of a Credit Committee to discuss portfolio and policy changes, and (g) regular meetings of an Asset Quality Committee which reviews the status of individual loans.

The Company's lenders are responsible for assigning risk ratings to loans using the parameters set forth in the Company's Credit Policy. The risk ratings are reviewed for accuracy, on a sample basis, by the Company's Loan Review department, which operates independently of loan production. These risk ratings are used in calculating the level of the allowance for loan losses.

Calculations of the allowance for loan losses are prepared quarterly by the Loan Review department. The calculations are reviewed for adequacy each quarter by the Company's Credit Committee, Audit and Compliance Committee, and Board of Directors. In determining the adequacy of the allowance for loan losses, factors which are considered include the Company's historical loss experience; the size and composition of the loan portfolio; loan risk ratings; nonperforming loans; impaired loans; other problem credits; the value and adequacy of collateral and guarantors; and national and local economic conditions.

The Company's allowance for loan losses has three basic components: the formula allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change. The formula allowance uses a historical loss view as an indicator of future losses along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries; trends in volume and terms of loans; effects of changes in underwriting standards; experience of lending staff and economic conditions; and portfolio concentrations. In the formula allowance, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The adjusted loss factor is multiplied by the period-end balances for each risk-grade category. The formula allowance is calculated for a range of outcomes. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The unallocated allowance includes estimated losses whose impact on the portfolio has yet to be recognized in either the formula or specific allowance. The use of these values is inherently subjective and actual losses could be greater or less than the estimates.

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No single statistic, formula, or measurement determines the adequacy of the allowance. Management makes difficult, subjective, and complex judgments about matters that are inherently uncertain, and different amounts would be reported under different conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific loan categories and specific loans (the allocated allowance). The entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified losses.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, management cannot provide assurance that, in any particular period, the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time, including economic conditions, industry trends, and ongoing internal and external examination processes. The allowance is subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance in comparison to peer banks.

The Southern Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Companies within these industries, especially furniture manufacturing, have also closed plants for reasons similar to those noted above. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans. Also, the current economic and credit crisis, which is resulting in rising unemployment and increasing bankruptcies, foreclosures and bank failures nationally, may further intensify the economic pressure in our markets.

The allowance for loan losses was \$7,824,000 at December 31, 2008, compared with \$7,395,000 and \$7,264,000 at December 31, 2007 and 2006, respectively. The allowance for loan losses as a percentage of loans at each of these dates was 1.37%, 1.34%, and 1.34%, respectively. The provision for loan losses was \$1,620,000 in 2008, \$403,000 in 2007, and \$58,000 in 2006.

Loans charged-off net of recoveries totaled \$1,191,000 in 2008, \$272,000 in 2007, and \$501,000 in 2006. One residential construction and development loan, secured by undeveloped and partially-developed land in the Triad area of North Carolina, accounted for \$575,000 of the net charge-offs in 2008. Table 14 presents the Company's loan loss and recovery experience for the past five years.

The allowance for loan losses is allocated to loan types based upon historical loss factors; risk grades on individual loans; portfolio analyses of smaller balance, homogenous loans; and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national and local economic trends and conditions; and concentrations of credit. Table 12 summarizes the allocation of the allowance for loan losses for the past five years.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The following table shows loans that were considered impaired as of year end.

Table 11 - Impaired Loans

| | December 31, | | | | |
|--------------------------|--------------|----------|----------|----------|----------|
| (in thousands) | 2008 | 2007 | 2006 | 2005 | 2004 |
| Not on nonaccrual status | \$ 1,921 | \$ 2,255 | \$ 262 | \$ 537 | \$ 1,007 |
| On nonaccrual status | 1,271 | 1,310 | 1,114 | 2,995 | 5,303 |
| Total impaired loans | \$ 3,192 | \$ 3,565 | \$ 1,376 | \$ 3,532 | \$ 6,310 |

Table of ContentsTable 12 - Allocation of Allowance for Loan Losses
(dollars in thousands)

| | 2008 | | 2007 | | December 31, 2006 | | 2005 | | 2004 | |
|--|----------|-------|----------|-------|----------------------|-------|----------|-------|----------|-------|
| | \$ | % (1) | \$ | % (1) | \$ | % (1) | \$ | % (1) | \$ | % (1) |
| Commercial (including commercial real estate) | \$ 5,163 | 62% | \$ 5,056 | 62% | \$ 4,467 | 61% | \$ 3,897 | 64% | \$ 5,927 | 61% |
| Residential real estate | 2,335 | 37 | 1,852 | 36 | 2,119 | 37 | 1,462 | 33 | 1,231 | 35 |
| Consumer | 326 | 1 | 443 | 2 | 521 | 2 | 653 | 3 | 816 | 4 |
| Unallocated | - | - | 44 | - | 157 | - | 97 | - | 8 | - |
| Total | \$ 7,824 | 100% | \$ 7,395 | 100% | \$ 7,264 | 100% | \$ 6,109 | 100% | \$ 7,982 | 100% |

(1) Represents the percentage of loans in each category to total loans.

Table 13 - Asset Quality Ratios

| | As of or for the Years Ended December 31, | | | | |
|---|---|--------|--------|--------|--------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Allowance to loans* | 1.37% | 1.34% | 1.34% | 1.46% | 1.96% |
| Net charge-offs to year-end allowance | 15.23 | 3.68 | 6.90 | 38.27 | 5.07 |
| Net charge-offs to average loans | 0.21 | 0.05 | 0.10 | 0.56 | 0.10 |
| Nonperforming assets to total assets* | 0.91 | 0.42 | 0.45 | 0.72 | 1.35 |
| Nonperforming loans to loans* | 0.50 | 0.48 | 0.63 | 1.02 | 1.99 |
| Provision to net charge-offs | 136.02 | 148.16 | 11.58 | 19.89 | 764.20 |
| Provision to average loans | 0.29 | 0.07 | 0.01 | 0.11 | 0.77 |
| Allowance to nonperforming | 275.01 | 280.22 | 212.09 | 142.97 | 98.39 |

loans*

* - at year end

Table of ContentsTable 14 - Summary of Loan Loss Experience
(in thousands)

| | Year Ended December 31, | | | | |
|-----------------------------------|-------------------------|----------|----------|----------|----------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Balance at beginning of period | \$ 7,395 | \$ 7,264 | \$ 6,109 | \$ 7,982 | \$ 5,292 |
| Allowance from acquisition | - | - | 1,598 | - | - |
| Charge-offs: | | | | | |
| Construction and land development | 1,007 | - | 1 | - | - |
| Commercial real estate | 61 | 54 | 136 | 2,249 | - |
| Residential real estate | 196 | 140 | 163 | 35 | 85 |
| Home equity | 62 | 19 | - | - | 44 |
| Total real estate | 1,326 | 213 | 300 | 2,284 | 129 |
| Commercial and industrial | 63 | 103 | 354 | 76 | 169 |
| Consumer | 175 | 199 | 259 | 217 | 357 |
| Total charge-offs | 1,564 | 515 | 913 | 2,577 | 655 |
| Recoveries: | | | | | |
| Construction and land development | 71 | - | 1 | - | - |
| Commercial real estate | 101 | 15 | 98 | 46 | 49 |
| Residential real estate | 3 | 3 | 11 | 3 | - |
| Home equity | - | 1 | 1 | - | - |
| Total real estate | 175 | 19 | 111 | 49 | 49 |
| Commercial and industrial | 18 | 50 | 108 | 11 | 45 |
| Consumer | 180 | 174 | 193 | 179 | 156 |
| Total recoveries | 373 | 243 | 412 | 239 | 250 |
| Net charge-offs | 1,191 | 272 | 501 | 2,338 | 405 |
| Provision for loan losses | 1,620 | 403 | 58 | 465 | 3,095 |
| Balance at end of period | \$ 7,824 | \$ 7,395 | \$ 7,264 | \$ 6,109 | \$ 7,982 |

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt

restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented 0.91% of total loans at December 31, 2008, up from 0.48% at December 31, 2007. There were no troubled debt restructurings at the end of any of the years presented in the table.

Table of ContentsTable 15 - Nonperforming Assets
(in thousands)

| | December 31, | | | | |
|---|--------------|----------|----------|----------|----------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Nonaccrual loans: | | | | | |
| Real estate | \$ 2,730 | \$ 2,488 | \$ 3,195 | \$ 4,098 | \$ 7,005 |
| Commercial | 73 | 107 | 151 | 12 | 853 |
| Agricultural | - | - | - | - | 12 |
| Consumer | 42 | 44 | 79 | 107 | 243 |
| Total nonaccrual loans | 2,845 | 2,639 | 3,425 | 4,217 | 8,113 |
| Restructured loans | - | - | - | - | - |
| Loans past due 90 days and accruing interest: | | | | | |
| Real estate | - | - | - | 46 | - |
| Commercial | - | - | - | 10 | - |
| Agricultural | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total past due loans | - | - | - | 56 | - |
| Total nonperforming loans | 2,845 | 2,639 | 3,425 | 4,273 | 8,113 |
| Foreclosed real estate | 4,311 | 632 | 99 | 188 | 221 |
| Total nonperforming assets | \$ 7,156 | \$ 3,271 | \$ 3,524 | \$ 4,461 | \$ 8,334 |

Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Average deposits decreased 8,511,000, or 1.4%, in 2008 after increasing \$1,350,000, or 0.2%, in 2007. Period-end deposits increased \$ 7,917,000, or 1.4%, from December 31, 2007 to December 31, 2008. The increase in period-end deposits is attributed primarily to a special interest bearing demand deposit rate arrangement with a municipality.

During 2008, demand deposits increased \$7,853,000, or 3.9%, money market deposits increased \$6,361,000, or 12.7%, while savings deposits declined \$2,776,000, or 4.5% and certificates of deposit declined \$3,521,000, or 1.3%, as customers sought higher-yielding accounts.

Table 16 - Deposits
(in thousands, except rates)

| | 2008 | | December 31, 2007 | | 2006 | |
|--|--------------------|-------|----------------------|-------|--------------------|-----------------|
| | Average Balance | Rate | Average Balance | Rate | Average Balance | Average Rate |
| Demand deposits - noninterest bearing | \$ 98,157 | -% | \$ 102,003 | -% | \$ 102,117 | -% |
| Demand deposits - interest bearing | 109,492 | 0.73 | 107,834 | 1.44 | 105,320 | 1.44 |
| Money market | 53,659 | 1.88 | 52,843 | 2.70 | 48,124 | 2.45 |
| Savings | 61,620 | 0.54 | 66,246 | 1.28 | 77,445 | 1.24 |
| Time | 258,773 | 3.92 | 261,286 | 4.48 | 255,856 | 3.79 |
| | \$ 581,701 | 2.11% | \$ 590,212 | 2.63% | \$ 588,862 | 2.27% |

Table 17 - Certificates of Deposit of \$100,000 or More
(in thousands)

Certificates of deposit at December 31, 2008 in amounts of \$100,000 or more were classified by maturity as follows:

| | | |
|--------------------------|----|---------|
| 3 months or less | \$ | 19,666 |
| Over 3 through 6 months | | 25,405 |
| Over 6 through 12 months | | 19,086 |
| Over 12 months | | 43,029 |
| | \$ | 107,186 |

Borrowed Funds

In addition to internal deposit generation, the Company also relies on borrowed funds as a supplemental source of funding. Borrowed funds consist of customer repurchase agreements, overnight borrowings from the Federal Home Loan Bank of Atlanta and longer-term FHLB advances, and trust preferred capital notes. Customer repurchase agreements are borrowings collateralized by securities of the U.S. Government or its agencies and mature daily. The Company considers these accounts to be stable sources of funds, as they represent customer sweep accounts. The securities underlying these agreements remain under the Company's control.

The following table presents information pertaining to the Company's short-term borrowed funds.

Table 18 - Short-Term Borrowings
(dollars in thousands)

| | December 31, | |
|--------------------------------|--------------|-----------|
| | 2008 | 2007 |
| Customer repurchase agreements | \$ 51,741 | \$ 47,891 |
| FHLB overnight borrowings | 7,850 | 7,200 |
| Total | \$ 59,591 | \$ 55,091 |
| Weighted interest rate | 1.75% | 3.78% |
| Average for the year ended: | | |
| Outstanding | \$ 62,082 | \$ 48,435 |
| Interest rate | 2.62% | 3.84% |
| Maximum month-end outstanding | \$ 81,598 | \$ 55,091 |

Shareholders' Equity

The Company's goal with capital management is to generate attractive returns on equity and pay a high rate of dividends while maintaining capital sufficient to be classified as "well capitalized" under regulatory capital ratios and to support growth.

Shareholders' equity was \$102,300,000 at December 31, 2008 and \$101,511,000 at December 31, 2007. This increase was largely the result of net income but was partially offset by dividends, stock repurchases and the effect of changes in unfunded pension liability.

Shareholders' equity was \$101,511,000 at December 31, 2007 and \$94,992,000 at December 31, 2006. This increase was largely the result of net income and comprehensive income. These increases were partially offset by dividends and stock repurchases.

The Company declared and paid quarterly dividends totaling \$0.92, \$0.91, and \$0.87 per share of common stock in 2008, 2007, and 2006, respectively. Cash dividends in 2008 totaled \$5,606,000 and represented a 69.9% payout of 2008 net income, compared to 48.8% in 2007 and 45.6% in 2006.

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One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Shareholders' equity was 12.96% of assets at December 31, 2008 and 13.14% at December 31, 2007. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios that the Company and its banking subsidiary are required to maintain. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholder's equity and trust preferred capital notes, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another regulatory indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At December 31, 2008, the Company's Tier I and total capital ratios were 16.67% and 17.92%, respectively. At December 31, 2007, these ratios were 17.03% and 18.28%, respectively. The ratios for both years exceeded the regulatory requirements. The Company's leverage ratios were 13.04% and 12.98% at December 31, 2008 and 2007, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

As mandated by bank regulations, the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." These regulations require the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier I risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of December 31, 2008 and 2007, that the Company met the requirements to be considered "well capitalized."

CONTRACTUAL OBLIGATIONS

The following items are contractual obligations of the Company as of December 31, 2008 (in thousands):

| | Payments Due By Period | | | | |
|-------------------------------|------------------------|-----------------|--------------|--------------|-------------------------|
| | Total | Under 1 Year | 1-3 Years | 3-5 Years | More than 5 years |
| Time deposits | \$ 261,064 | \$ 181,352 | \$ 49,873 | \$ 29,839 | \$ - |
| FHLB borrowings | 21,637 | 12,850 | - | 8,000 | 787 |
| Repurchase agreements | 51,741 | 51,741 | - | - | - |
| Operating leases | 702 | 296 | 325 | 79 | 2 |
| Trust preferred capital notes | 20,619 | - | - | - | 20,619 |

OFF-BALANCE SHEET ACTIVITIES

The Company enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. Other than AMNB Statutory Trust I, formed in 2006 to issue Trust Preferred Securities, the Company does not have any off-balance sheet subsidiaries. Refer to Note 12 of the Consolidated Financial Statements for a discussion of AMNB Statutory Trust I. Off-balance sheet transactions were as follows (in thousands):

| Off-Balance Sheet Transactions | December 31, | |
|-------------------------------------|--------------|------------|
| | 2008 | 2007 |
| Commitments to extend credit | \$ 146,399 | \$ 144,301 |
| Standby letters of credit | 2,858 | 6,222 |
| Mortgage loan rate-lock commitments | 2,031 | 2,215 |

Commitments to extend credit to customers represent legally binding agreements with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future funding requirements. Standby letters of credit are conditional commitments issued by the Company guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements.

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ITEM 8 – FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Table 19 - Quarterly Financial Results
(in thousands, except per share amounts)

| 2008 | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|-------------------|------------------|-------------------|------------------|
| Interest income | \$ 10,225 | \$ 10,599 | \$ 10,788 | \$ 11,260 |
| Interest expense | 3,503 | 3,743 | 4,058 | 4,535 |
| Net interest income | 6,722 | 6,856 | 6,730 | 6,725 |
| Provision for loan losses | 600 | 280 | 600 | 140 |
| Net interest income after provision for loan losses | 6,122 | 6,576 | 6,130 | 6,585 |
| Noninterest income | 1,875 | 2,062 | 1,841 | 2,135 |
| Noninterest expense | 5,547 | 5,485 | 5,643 | 5,449 |
| Income before income taxes | 2,450 | 3,153 | 2,328 | 3,271 |
| Income taxes | 767 | 929 | 519 | 966 |
| Net income | \$ 1,683 | \$ 2,224 | \$ 1,809 | \$ 2,305 |
| Per common share: | | | | |
| Net income - basic | \$ 0.28 | \$ 0.36 | \$ 0.30 | \$ 0.38 |
| Net income - diluted | 0.28 | 0.36 | 0.30 | 0.38 |
| Cash dividends | 0.23 | 0.23 | 0.23 | 0.23 |
| | | | | |
| 2007 | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Interest income | \$ 12,300 | \$ 12,293 | \$ 12,106 | \$ 11,898 |
| Interest expense | 4,842 | 4,947 | 4,823 | 4,758 |
| Net interest income | 7,458 | 7,346 | 7,283 | 7,140 |
| Provision for loan losses | 100 | - | - | 303 |
| Net interest income after provision for loan losses | 7,358 | 7,346 | 7,283 | 6,837 |
| Noninterest income | 1,903 | 2,276 | 2,431 | 2,212 |
| Noninterest expense | 5,329 | 5,379 | 5,448 | 5,170 |

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| | | | | |
|----------------------------|----------|----------|----------|----------|
| Income before income taxes | 3,932 | 4,243 | 4,266 | 3,879 |
| Income taxes | 1,157 | 1,309 | 1,235 | 1,175 |
| Net income | \$ 2,775 | \$ 2,934 | \$ 3,031 | \$ 2,704 |
| Per common share: | | | | |
| Net income - basic | \$ 0.45 | \$ 0.48 | \$ 0.49 | \$ 0.44 |
| Net income - diluted | 0.45 | 0.48 | 0.49 | 0.44 |
| Cash dividends | 0.23 | 0.23 | 0.23 | 0.22 |

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ITEM 9A – CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Interim Principal Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934), as amended (the "Exchange Act") as of December 31, 2007. Based on this evaluation, the Chief Executive Officer and Interim Principal Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended December 31, 2008 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Management regularly monitors its internal control over financial reporting, and actions are taken to correct deficiencies as they are identified.

Under the supervision and with the participation of management, including the principal executive officer and interim principal financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting. This assessment was based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation under the framework in Internal Control – Integrated Framework, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2008, as such term is defined in Exchange Act Rules 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, because of changes in conditions, internal control effectiveness may vary over time.

The Company's independent registered public accounting firm, Yount, Hyde and Barbour, P.C., has audited the Company's internal control over financial reporting as of December 31, 2008, as stated in their report included herein. Yount, Hyde and Barbour, P.C. also audited the Company's consolidated financial statements as of and for the year ended December 31, 2008.

/s/ Charles H. Majors
Charles H. Majors
President and Chief Executive Officer

/s/ Charles H. Majors

Charles H. Majors
Interim Principal Financial Officer

March 10, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
American National Bankshares Inc.
Danville, Virginia

We have audited the accompanying consolidated balance sheets of American National Bankshares Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American National Bankshares Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), American National Bankshares Inc. and subsidiaries' internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 10, 2009 expressed an unqualified opinion on the effectiveness of American National Bankshares Inc. and subsidiaries' internal control over financial reporting.

Winchester, Virginia
March 10, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
American National Bankshares Inc.
Danville, Virginia

We have audited American National Bankshares Inc. and subsidiaries' internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. American National Bankshares Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, American National Bankshares Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets and the related consolidated statements of income, changes in shareholders' equity and cash flows of American National Bankshares Inc. and subsidiaries and our report dated March 10, 2009 expressed an unqualified opinion.

Winchester, Virginia
March 10, 2009

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American National Bankshares Inc. and Subsidiaries
Consolidated Balance Sheets
December 31, 2008 and 2007
(Dollars in thousands, except share and per share data)

| ASSETS | 2008 | 2007 |
|--|------------|------------|
| Cash and due from banks | \$ 14,986 | \$ 18,155 |
| Interest-bearing deposits in other banks | 9,112 | 149 |
| Securities available for sale, at fair value | 133,695 | 145,159 |
| Securities held to maturity (fair value of \$7,391 in 2008 and \$12,250 in 2007) | 7,121 | 11,990 |
| Total securities | 140,816 | 157,149 |
| Loans held for sale | 1,764 | 1,368 |
| Loans, net of unearned income | 571,110 | 551,391 |
| Less allowance for loan losses | (7,824) | (7,395) |
| Net loans | 563,286 | 543,996 |
| Premises and equipment, net | 17,431 | 13,348 |
| Other real estate owned | 4,311 | 632 |
| Goodwill | 22,468 | 22,468 |
| Core deposit intangibles, net | 2,075 | 2,452 |
| Accrued interest receivable and other assets | 12,935 | 12,571 |
| Total assets | \$ 789,184 | \$ 772,288 |
| LIABILITIES and SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits -- noninterest bearing | \$ 95,703 | \$ 99,231 |
| Demand deposits -- interest bearing | 116,132 | 104,751 |
| Money market deposits | 56,615 | 50,254 |
| Savings deposits | 59,624 | 62,400 |
| Time deposits | 261,064 | 264,585 |
| Total deposits | 589,138 | 581,221 |
| Short-term borrowings: | | |
| Customer repurchase agreements | 51,741 | 47,891 |
| Other short-term borrowings | 7,850 | 7,200 |
| Long-term borrowings | 13,787 | 8,937 |
| Trust preferred capital notes | 20,619 | 20,619 |
| Accrued interest payable and other liabilities | 3,749 | 4,909 |

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| | | |
|--|------------|------------|
| Total liabilities | 686,884 | 670,777 |
| Shareholders' equity: | | |
| Preferred stock, \$5 par, 200,000 shares authorized, none outstanding | - | - |
| Common stock, \$1 par, 10,000,000 shares authorized, 6,085,628 shares outstanding at December 31, 2008 and 6,118,717 shares outstanding at December 31, 2007 | 6,086 | 6,119 |
| Capital in excess of par value | 26,491 | 26,425 |
| Retained earnings | 71,090 | 69,409 |
| Accumulated other comprehensive (loss), net | (1,367) | (442) |
| Total shareholders' equity | 102,300 | 101,511 |
| Total liabilities and shareholders' equity | \$ 789,184 | \$ 772,288 |

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

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American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Income
For the Years Ended December 31, 2008, 2007, and 2006
(Dollars in thousands, except share and per share data)

| | 2008 | 2007 | 2006 |
|---|-----------|-----------|-----------|
| Interest and Dividend | | | |
| Income: | | | |
| Interest and fees on loans | \$ 35,941 | \$ 41,499 | \$ 37,361 |
| Interest and dividends on securities: | | | |
| Taxable | 4,795 | 4,409 | 5,034 |
| Tax-exempt | 1,621 | 1,690 | 1,743 |
| Dividends | 214 | 320 | 312 |
| Other interest income | 301 | 679 | 620 |
| Total interest and dividend income | 42,872 | 48,597 | 45,070 |
| Interest Expense: | | | |
| Interest on deposits | 12,280 | 15,535 | 13,349 |
| Interest on short-term borrowings | 1,629 | 1,860 | 1,453 |
| Interest on long-term borrowings | 557 | 602 | 852 |
| Interest on trust preferred capital notes | 1,373 | 1,373 | 1,007 |
| Total interest expense | 15,839 | 19,370 | 16,661 |
| Net Interest Income | 27,033 | 29,227 | 28,409 |
| Provision for Loan Losses | 1,620 | 403 | 58 |
| Net Interest Income after Provision for Loan Losses | 25,413 | 28,824 | 28,351 |
| Noninterest Income: | | | |
| Trust fees | 3,467 | 3,578 | 3,374 |
| Service charges on deposit accounts | 2,324 | 2,531 | 2,654 |
| Other fees and commissions | 857 | 786 | 744 |
| Mortgage banking income | 788 | 954 | 709 |
| Brokerage fees | 431 | 550 | 419 |
| Securities gains (losses), net | (450) | 135 | 62 |
| Impairment of securities | - | (362) | - |
| Other | 496 | 650 | 496 |
| Total noninterest income | 7,913 | 8,822 | 8,458 |
| Noninterest Expense: | | | |
| Salaries | 9,792 | 9,688 | 9,520 |
| Employee benefits | 3,001 | 2,749 | 2,506 |
| Occupancy and equipment | 3,701 | 3,527 | 2,977 |
| Bank franchise tax | 694 | 663 | 651 |

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| | | | |
|--------------------------------------|----------|-----------|-----------|
| Core deposit intangible amortization | 377 | 377 | 414 |
| Other | 4,559 | 4,322 | 4,196 |
| Total noninterest expense | 22,124 | 21,326 | 20,264 |
| Income Before Income Taxes | | | |
| Taxes | 11,202 | 16,320 | 16,545 |
| Income Taxes | 3,181 | 4,876 | 5,119 |
| Net Income | \$ 8,021 | \$ 11,444 | \$ 11,426 |

Net Income Per Common Share:

| | | | |
|---------|---------|---------|---------|
| Basic | \$ 1.32 | \$ 1.86 | \$ 1.91 |
| Diluted | \$ 1.31 | \$ 1.86 | \$ 1.90 |

Average Common Shares

Outstanding:

| | | | |
|---------|-----------|-----------|-----------|
| Basic | 6,096,649 | 6,139,095 | 5,986,262 |
| Diluted | 6,105,154 | 6,161,825 | 6,020,071 |

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

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American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2008, 2007, and 2006
(Dollars in thousands)

| | Common Stock | | Capital in Excess of Par Value | Retained Earnings | Accumulated | |
|---|--------------|----------|---|----------------------|--|----------------------------------|
| | Shares | Amount | | | Other Comprehensive Income (Loss) | Total Shareholders' Equity |
| Balance, December 31, 2005 | 5,441,758 | \$ 5,442 | \$ 9,588 | \$ 59,109 | \$ (720) | \$ 73,419 |
| Net income | - | - | - | 11,426 | - | 11,426 |
| Change in unrealized losses on securities available for sale, net of tax, \$32 | - | - | - | - | 58 | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax, \$(21) | - | - | - | - | (41) | |
| Other comprehensive income | | | | | 17 | 17 |
| Total comprehensive income | | | | | | 11,443 |
| Adjustment to initially apply FASB statement No. 158, net of tax, \$(789) | - | - | - | - | (1,465) | (1,465) |
| Issuance of common stock in exchange for net assets acquisition | 746,944 | 747 | 16,799 | - | - | 17,546 |
| Stock repurchased and retired | (39,100) | (39) | (132) | (741) | - | (912) |
| | 12,263 | 12 | 159 | - | - | 171 |

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| | | | | | | |
|--|-----------|-------|--------|---------|---------|---------|
| Stock options exercised | | | | | | |
| Cash dividends declared, \$0.87 per share | - | - | - | (5,210) | - | (5,210) |
| Balance, December 31, 2006 | 6,161,865 | 6,162 | 26,414 | 64,584 | (2,168) | 94,992 |
| Net income | - | - | - | 11,444 | - | 11,444 |
| Change in unrealized gains on securities available for sale, net of tax, \$874 | - | - | - | - | 1,622 | |
| Add: Reclassification adjustment for losses on impairment of securities, net of tax, \$127 | | | | | 235 | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax, \$(47) | - | - | - | - | (88) | |
| Change in unfunded pension liability, net of tax, \$(23) | | | | | (43) | |
| Other comprehensive income | | | | | 1,726 | 1,726 |
| Total comprehensive income | | | | | | 13,170 |
| Stock repurchased and retired | (61,900) | (62) | (265) | (1,032) | - | (1,359) |
| Stock options exercised | 18,752 | 19 | 276 | - | - | 295 |
| Cash dividends declared, \$0.91 per share | - | - | - | (5,587) | - | (5,587) |
| Balance, December 31, 2007 | 6,118,717 | 6,119 | 26,425 | 69,409 | (442) | 101,511 |
| Net income | - | - | - | 8,021 | - | 8,021 |

| | | | | | | |
|--|-----------|----------|-----------|-----------|------------|------------|
| Change in unrealized gains on securities available for sale, net of tax, \$359 | - | - | - | - | 665 | |
| Add: Reclassification adjustment for losses on securities available for sale, net of tax, \$157 | - | - | - | - | 293 | |
| Change in unfunded pension liability, net of tax, \$(1,015) | | | | | | (1,883) |
| Other comprehensive loss | | | | | (925) | (925) |
| Total comprehensive income | | | | | | 7,096 |
| Change in pension plan measurement date, net of tax, \$(40) | | | | (75) | | (75) |
| Stock repurchased and retired | (46,150) | (46) | (199) | (659) | - | (904) |
| Stock options exercised | 13,061 | 13 | 206 | - | - | 219 |
| Stock compensation expense | - | - | 59 | - | - | 59 |
| Cash dividends declared, \$0.92 per share | - | - | - | (5,606) | - | (5,606) |
| Balance, December 31, 2008 | 6,085,628 | \$ 6,086 | \$ 26,491 | \$ 71,090 | \$ (1,367) | \$ 102,300 |

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

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American National Bankshares Inc. and Subsidiaries
 Consolidated Statements of Cash Flows
 For the Years Ended December 31, 2008, 2007, and 2006
 (Dollars in thousands)

| | 2008 | 2007 | 2006 |
|---|----------|-----------|-----------|
| Cash Flows from Operating Activities: | | | |
| Net income | \$ 8,021 | \$ 11,444 | \$ 11,426 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Provision for loan losses | 1,620 | 403 | 58 |
| Depreciation | 1,358 | 1,178 | 993 |
| Core deposit intangible amortization | 377 | 377 | 414 |
| Net amortization (accretion) of bond premiums and discounts | | (188) | (51) |
| Net loss (gain) on sale or call of securities | 450 | (135) | (62) |
| Impairment of securities | - | 362 | - |
| Gain on sale of loans held for sale | (669) | (733) | (434) |
| Proceeds from sales of loans held for sale | 29,642 | 31,451 | 15,673 |
| Originations of loans held for sale | (29,369) | (30,424) | (16,187) |
| Net loss (gain) on sale of foreclosed real estate | 20 | (6) | (7) |
| Net change in valuation allowance on foreclosed real estate | | - | 10 |
| Net loss (gain) on sale of premises and equipment | 7 | (8) | - |
| Stock-based compensation expense | 59 | - | - |
| Deferred income tax (benefit) expense | 691 | (67) | 732 |
| Net change in interest receivable | 398 | 316 | (54) |
| Net change in other assets | (3,852) | 699 | (1,369) |
| Net change in interest payable | (373) | 39 | 429 |
| Net change in other liabilities | (862) | (257) | (703) |
| Net cash provided by operating activities | 7,335 | 14,451 | 10,868 |
| Cash Flows from Investing Activities: | | | |

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| | | | |
|---|-----------|-----------|-----------|
| Proceeds from sales of securities available for sale | 1,098 | 1,070 | 503 |
| Proceeds from maturities and calls of securities available for sale | | 54,965 | 57,920 |
| Proceeds from maturities and calls of securities held to maturity | | 1,884 | 4,491 |
| Purchases of securities available for sale | (28,636) | (49,763) | (51,716) |
| Net (increase) decrease in loans | (24,970) | (9,933) | 10,278 |
| Proceeds from sale of premises and equipment | - | 25 | 324 |
| Purchases of premises and equipment | (5,448) | (2,105) | (1,045) |
| Proceeds from sales of other real estate owned | 317 | 30 | 421 |
| Increase in other real estate owned | (26) | (59) | (230) |
| Cash paid in acquisition | - | - | (17,087) |
| Cash acquired in acquisition | - | - | 2,956 |
| Net cash (used in) provided by investing activities | (12,517) | (3,886) | 6,815 |
| Cash Flows from Financing Activities: | | | |
| Net change in demand, money market, and savings deposits | 11,438 | (17,884) | (9,915) |
| Net change in time deposits | (3,521) | (9,423) | (15,180) |
| Net change in customer repurchase agreements | 3,850 | 14,523 | (3,835) |
| Net change in other short-term borrowings | 650 | 7,200 | (2,151) |
| Net change in long-term borrowings | 4,850 | (6,150) | (2,500) |
| Net change in trust preferred capital notes | - | - | 20,619 |
| Cash dividends paid | (5,606) | (5,587) | (5,210) |
| Repurchase of stock | (904) | (1,359) | (912) |
| Proceeds from exercise of stock options | 219 | 295 | 171 |
| Net cash provided by (used in) financing activities | 10,976 | (18,385) | (18,913) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 5,794 | (7,820) | (1,230) |
| Cash and Cash Equivalents at Beginning of Period | 18,304 | 26,124 | 27,354 |
| | \$ 24,098 | \$ 18,304 | \$ 26,124 |

Cash and Cash Equivalents
at End of Period

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

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American National Bankshares Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008, 2007, and 2006

Note 1 – Summary of Significant Accounting Policies

Nature of Operations and Consolidation

The consolidated financial statements include the accounts of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the “Company”). American National Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the 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 and the valuation of foreclosed real estate.

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “Trust”) and a wholly owned subsidiary of the Company was formed for the purpose of issuing preferred securities (the “Trust Preferred Securities”) in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation which occurred in April 2006. Refer to Note 12 for further details concerning this variable interest entity.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the Trust, as detailed in Note 12.

Cash and Cash Equivalents

Cash includes cash on hand and cash with correspondent banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less and are subject to an insignificant risk of change in value. Cash and cash equivalents are carried at cost.

Securities

The Company classifies securities as either held to maturity or available for sale.

Debt securities that management has both the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost.

Securities which may be used to meet liquidity needs arising from deposit and loan fluctuations or changes in market conditions are classified as available for sale. Securities available for sale are reported at estimated fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of tax. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized impairment losses. In estimating other than

temporary impairment losses, management considers (1) the length of time and extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for anticipated recovery in fair value. Gains or losses realized from the sale of securities available for sale are recorded on the trade date and are determined using the specific identification method.

The Company does not permit the purchase or sale of trading account securities.

Due to the nature and restrictions placed on the Company's investment in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank, these securities have been classified as restricted equity securities and carried at cost.

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Loans Held for Sale

Secondary market mortgage loans are designated as held for sale at the time of their origination. These loans are pre-sold with servicing released and the Company does not retain any interest after the loans are sold. These loans consist primarily of fixed-rate, single-family residential mortgage loans which meet the underwriting characteristics of certain government-sponsored enterprises (conforming loans). In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be committed, thus limiting interest rate risk. Loans held for sale are carried at estimated fair value in the aggregate. Gains on sales of loans are recognized at the loan closing date and are included in noninterest income for the period.

Derivative Loan Commitments

The Company enters into mortgage loan commitments whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheets with net changes in their fair values recorded in other expenses. Derivative loan commitments resulted in income of \$9,000 for 2008, \$21,000 in expense for 2007, and \$10,000 in income for 2006.

The period of time between issuance of a loan commitment 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 contracts, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed the interest rate risk on the loan. As a result, the Company is not generally exposed to significant 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 efforts 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 change in the estimated value of the underlying assets while taking into consideration the probability that the loan will be funded.

Loans

The Company grants mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is secured by real estate. 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 pay-off generally are reported at their outstanding unpaid principal balance adjusted for the allowance for loan losses, and any deferred fees or costs. 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 accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off when the loan is 120 days past due, unless secured and in process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Substandard and doubtful risk graded commercial, commercial real estate, and construction loans equal to or greater than \$100,000 on an unsecured basis, and equal to or greater than \$250,000 on a secured basis are reviewed for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment and establishing a specific allowance include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

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Generally, large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The Company's policy for recognizing interest income on impaired loans is consistent with its nonaccrual policy.

Accounting for Certain Loans or Debt Securities Acquired in a Transfer

In January 2005, American Institute of Certified Public Accountants Statement of Position ("SOP") 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, was adopted for loan acquisitions. SOP 03-3 requires acquired loans to be recorded at fair value and prohibits carrying over valuation allowances in the initial accounting for acquired impaired loans. Loans carried at fair value, mortgage loans held for sale, and loans to borrowers in good standing under revolving credit agreements are excluded from the scope of SOP 03-3. SOP 03-3 limits the yield that may be accreted to the excess of the undiscounted expected cash flows over the investor's initial investment in the loan. The excess of the contractual cash flows over expected cash flows may not be recognized as an adjustment of yield. Subsequent increases in cash flows expected to be collected are recognized prospectively through an adjustment of the loan's yield over its remaining life. Decreases in expected cash flows are recognized as impairments. Refer to Note 5 for disclosures required under SOP 03-3.

Allowance for Loan Losses

The allowance for loan losses is management's estimate of probable credit losses that are inherent in the loan portfolio at the balance sheet date. Increases to the allowance are made by charges to the provision for loan losses, which is reflected in the Consolidated Statements of Income. Loan balances deemed to be uncollectible are charged-off against the allowance. Recoveries of previously charged-off amounts are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the loan portfolio in light of historical charge-off experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. The allowance for loan losses has three basic components: the formula allowance, the specific allowance, and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses along with various economic factors and, as a result, could differ from the loss incurred in the future. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The unallocated allowance captures losses whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Actual losses could be greater or less than the estimates.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to thirty-nine years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful lives of the improvements, whichever is less. Software is generally amortized over three years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

Goodwill and Intangible Assets

The Company adopted Statement of Financial Accounting Standards (“SFAS”) 142, Goodwill and Other Intangible Assets, in January 2002. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, under SFAS 142, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Branch acquisition transactions were outside the scope of SFAS 142 and, accordingly, intangible assets related to such transactions continued to amortize upon the adoption of SFAS 142. The cost of purchased deposit relationships and other intangible assets, based on independent valuation, are being amortized over their estimated lives ranging from 8.25 years to 10 years.

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Trust Assets

Securities and other property held by the trust and investment services segment in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Foreclosed Real Estate

Foreclosed real estate represents real estate that has been acquired through loan foreclosures or deeds received in lieu of loan payments. Generally, such properties are appraised at the time acquired, and are recorded at the lower of cost or fair value less estimated selling costs. When appropriate, adjustments to cost are charged or credited to the allowance for foreclosed properties and are reflected in operations.

Income Taxes

The Company uses the balance sheet method to account for deferred income tax assets and liabilities. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Stock-Based Compensation

The Company's initial stock option plan terminated on December 31, 2006, which provided for the granting of incentive and non-statutory options to employees on a periodic basis. The Company's stock options had an exercise price equal to or greater than the fair value of the stock on the date of grant. Effective January 1, 2006, the Company adopted SFAS 123R, Share Based Payment, using the modified prospective method and as such, results for prior periods have not been restated. SFAS 123R requires public companies to recognize compensation expense related to stock-based compensation awards, such as stock options and restricted stock, in their income statements over the period during which an employee is required to provide service in exchange for such award.

In April 2008, the stockholders approved the 2008 Stock Incentive Plan which makes available 500,000 shares to be used to grant restricted stock awards and stock options in the form of incentive stock options and non-statutory stock options to participants. The plan will terminate on February 18, 2018, unless terminated sooner by the board of directors.

Earnings Per Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the impact of 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 consist solely of outstanding stock options, and are determined using the treasury method.

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Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in the funded status of a defined benefit postretirement plan, are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income. The components of accumulated other comprehensive income (loss), net of tax, included in the equity section of the balance sheets are as follows (in thousands):

| | December 31, | |
|---|--------------|----------|
| | 2008 | 2007 |
| Unrealized gains on securities available for sale | \$ 2,024 | \$ 1,066 |
| Unfunded pension liability | (3,391) | (1,508) |
| Total accumulated other comprehensive income (loss) | \$ (1,367) | \$ (442) |

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred, and were \$203,000, \$300,000, and \$267,000 in 2008, 2007, and 2006, respectively.

Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) reached a consensus on Emerging Issues Task Force (“EITF”) Issue 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements, (“EITF Issue 06-4”). In March 2007, the FASB reached a consensus on EITF Issue 06-10, Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements, (“EITF Issue 06-10”). Both of these standards require a company to recognize an obligation over an employee’s service period based upon the substantive agreement with the employee such as the promise to maintain a life insurance policy or provide a death benefit postretirement. The Company adopted the provisions of these standards effective January 1, 2008. The adoption of these standards was not material to the consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The Company adopted SFAS 157 effective January 1, 2008. The adoption of SFAS 157 was not material to the

consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (“SFAS 159”). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. The Company adopted SFAS 159 effective January 1, 2008. The Company decided not to report any existing financial assets or liabilities at fair value that are not already reported, thus the adoption of this statement did not have a material impact on the consolidated financial statements.

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In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), “Business Combinations” (“SFAS 141(R”). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity’s first year that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements, at this time.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51” (“SFAS 160”). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity’s first fiscal year that begins after December 15, 2008, with early adoption prohibited. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements, at this time.

In November 2007, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin No. 109, “Written Loan Commitments Recorded at Fair Value Through Earnings” (SAB 109). SAB 109 expresses the current view of the staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SEC registrants are expected to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. Implementation of SAB 109 by the Company on January 1, 2008, did not have a material impact on its consolidated financial statements.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110, “Use of a Simplified Method in Developing Expected Term of Share Options” (“SAB 110”). SAB 110 expresses the current view of the staff that it will accept a company’s election to use the simplified method discussed in SAB 107 for estimating the expected term of “plain vanilla” share options regardless of whether the company has sufficient information to make more refined estimates. The staff noted that it understands that detailed information about employee exercise patterns may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. Implementation of SAB 110 by the Company on January 1, 2008, did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of SFAS No. 133” (“SFAS No. 161”). SFAS No. 161 requires that an entity provide enhanced disclosures related to derivative and hedging activities. SFAS No. 161 is effective for the Company on January 1, 2009. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (“FSP”) No. 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP No. 142-3”). FSP No. 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB SFAS No. 142, “Goodwill and Other Intangible Assets” (“SFAS No. 142”). The intent of FSP No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the assets under SFAS No. 141(R). FSP No. 142-3 is effective for the Company on January 1, 2009, and applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. The adoption of FSP No. 142-3 is not expected to have a material impact on the Company’s consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (“SFAS No. 162”). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS No. 162 is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” Management does not expect the adoption of the provisions of SFAS No. 162 to have any impact on the consolidated financial statements.

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In September 2008, the FASB issued FASB Staff Position (“FSP”) 133-1 and FASB Interpretations (“FIN”) 45-4, “Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161” (“FSP 133-1 and FIN 45-4”). FSP 133-1 and FIN 45-4 require a seller of credit derivatives to disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, financial performance and cash flows. The disclosures required by FSP 133-1 and FIN 45-4 will be effective for the Company on December 31, 2008 and are not expected to have a material impact on the consolidated financial statements.

In October 2008, the FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active” (“FSP 157-3”). FSP 157-3 clarifies the application of SFAS No. 157 in determining the fair value of a financial asset during periods of inactive markets. FSP 157-3 was effective as of September 30, 2008 and did not have material impact on the Company’s consolidated financial statements.

In December 2008, the FASB issued FSP No. FAS 140-4 and FIN 46(R)-8, “Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities.” FSP No. FAS 140-4 and FIN 46(R)-8 requires enhanced disclosures about transfers of financial assets and interests in variable interest entities. The FSP is effective for interim and annual periods ending after December 15, 2008. Since the FSP requires only additional disclosures concerning transfers of financial assets and interest in variable interest entities, adoption of the FSP did not affect the Company’s financial condition, results of operations or cash flows.

In January 2009, the FASB reached a consensus on EITF Issue 99-20-1. This FSP amends the impairment guidance in EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in FASB Statement No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and other related guidance. The FSP is effective for interim and annual reporting periods ending after December 15, 2008 and shall be applied prospectively. The FSP was effective as of December 31, 2008 and did not have a material impact on the consolidated financial statements.

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Note 2 – Restrictions on Cash and Amounts Due From Banks

The Company is a member of the Federal Reserve System and is required to maintain certain levels of its cash and cash equivalents as reserves based on regulatory requirements. This reserve requirement was approximately \$7,795,000 at December 31, 2008 and \$7,368,000 at December 31, 2007.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2008 did not exceed the insurance limits of the Federal Deposit Insurance Corporation.

Note 3 - Securities

The amortized cost and estimated fair value of investments in debt and equity securities at December 31, 2008 and 2007 were as follows:

| (in thousands) | Amortized Cost | December 31, 2008 | | Estimated Fair Value |
|-------------------------------------|-------------------|---------------------|----------------------|-------------------------|
| | | Unrealized Gains | Unrealized Losses | |
| Securities available for sale: | | | | |
| Debt securities: | | | | |
| Federal agencies | \$ 43,331 | \$ 2,093 | \$ 8 | \$ 45,416 |
| Mortgage-backed | 45,139 | 1,040 | 496 | 45,683 |
| State and municipal | 36,726 | 653 | 74 | 37,305 |
| Corporate | 1,485 | 3 | 96 | 1,392 |
| Equity securities: | | | | |
| FHLB stock - restricted | 2,362 | - | - | 2,362 |
| Federal Reserve stock - restricted | 1,429 | - | - | 1,429 |
| Other | 108 | - | - | 108 |
| Total securities available for sale | 130,580 | 3,789 | 674 | 133,695 |
| Securities held to maturity: | | | | |
| Mortgage-backed | 254 | 10 | - | 264 |
| State and municipal | 6,867 | 261 | 1 | 7,127 |
| Total securities held to maturity | 7,121 | 271 | 1 | 7,391 |
| Total securities | \$ 137,701 | \$ 4,060 | \$ 675 | \$ 141,086 |

| (in thousands) | Amortized Cost | December 31, 2007 | | Estimated Fair Value |
|--------------------------------|-------------------|---------------------|----------------------|-------------------------|
| | | Unrealized Gains | Unrealized Losses | |
| Securities available for sale: | | | | |
| Debt securities: | | | | |
| Federal agencies | \$ 55,350 | \$ 1,059 | \$ 33 | \$ 56,376 |
| Mortgage-backed | 45,346 | 565 | 97 | 45,814 |
| State and municipal | 36,343 | 258 | 113 | 36,488 |
| Corporate | 1,485 | - | 40 | 1,445 |
| Equity securities: | | | | |
| FHLB stock - restricted | 2,125 | - | - | 2,125 |

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| | | | | |
|-------------------------------------|------------|----------|--------|------------|
| Federal Reserve stock - restricted | 1,429 | - | - | 1,429 |
| FNMA and FHLMC preferred stock | 1,346 | 42 | - | 1,388 |
| Other | 94 | - | - | 94 |
| Total securities available for sale | 143,518 | 1,924 | 283 | 145,159 |
| Securities held to maturity: | | | | |
| Mortgage-backed | 308 | 11 | - | 319 |
| State and municipal | 11,682 | 256 | 7 | 11,931 |
| Total securities held to maturity | 11,990 | 267 | 7 | 12,250 |
| Total securities | \$ 155,508 | \$ 2,191 | \$ 290 | \$ 157,409 |

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The amortized cost and estimated fair value of investments in securities at December 31, 2008, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities have both known principal repayment terms as well as unknown principal repayments due to potential borrower pre-payments, it is difficult to accurately predict the final maturity of these investments. Mortgage-backed securities are shown separately.

| (in thousands) | Available for Sale | | Held to Maturity | |
|--|--------------------|----------------------|------------------|----------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due in one year or less | \$ 13,734 | \$ 13,826 | \$ 540 | \$ 544 |
| Due after one year through five years | 50,309 | 52,578 | 2,538 | 2,604 |
| Due after five years through ten years | 10,884 | 11,107 | 3,789 | 3,979 |
| Due after ten years | 6,615 | 6,602 | - | - |
| Equity securities | 3,899 | 3,899 | - | - |
| Mortgage-backed securities | 45,139 | 45,683 | 254 | 264 |
| | \$ 130,580 | \$ 133,695 | \$ 7,121 | \$ 7,391 |

Gross realized gains and losses from the call of all securities or the sale of securities available for sale were as follows (in thousands):

| | For the Years Ended | | |
|-----------------|---------------------|--------|-------|
| | December 31, 2008 | 2007 | 2006 |
| Realized gains | \$ 51 | \$ 135 | \$ 62 |
| Realized losses | (501) | - | - |

Securities with a carrying value of approximately \$90,683,000 and \$85,313,000, at December 31, 2008 and 2007, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law.

Corporate bonds consist of investment grade debt securities, primarily issued by financial services companies.

The table below shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2008. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

| (in thousands) | Total Estimated Fair | Unrealized Loss | Less than 12 Months | | 12 Months or More | |
|----------------|----------------------|-----------------|---------------------|-----------------|-------------------|-----------------|
| | | | Estimated Fair | Unrealized Loss | Estimated Fair | Unrealized Loss |

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| | Value | | Value | | Value | |
|---------------------|-----------|--------|----------|--------|----------|--------|
| Federal agencies | \$ 1,583 | \$ 8 | \$ 1,583 | \$ 8 | \$ - | \$ - |
| Mortgage-backed | 4,484 | 496 | 3,468 | 472 | 1,016 | 24 |
| State and municipal | 3,581 | 75 | 3,581 | 75 | - | - |
| Corporate | 389 | 96 | - | - | 389 | 96 |
| Total | \$ 10,037 | \$ 675 | \$ 8,632 | \$ 555 | \$ 1,405 | \$ 120 |

Management evaluates securities for other than temporary impairment quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for anticipated recovery in fair value. The unrealized losses are attributable to interest rate changes and not credit concerns of the issuer. The Company has the intent and ability to hold these securities for the time necessary to recover the amortized cost.

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The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007.

| (in thousands) | Total | | Less than 12 Months | | 12 Months or More | |
|---------------------|----------------------|-----------------|----------------------|-----------------|----------------------|-----------------|
| | Estimated Fair Value | Unrealized Loss | Estimated Fair Value | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Federal agencies | \$ 7,459 | \$ 33 | \$ - | \$ - | \$ 7,459 | \$ 33 |
| Mortgage-backed | 10,194 | 97 | 3,508 | 35 | 6,686 | 62 |
| State and municipal | 17,858 | 120 | 2,087 | 12 | 15,771 | 108 |
| Corporate | 1,445 | 40 | - | - | 1,445 | 40 |
| Total | \$ 36,956 | \$ 290 | \$ 5,595 | \$ 47 | \$ 31,361 | \$ 243 |

Note 4 – Loans

Loans, excluding loans held for sale, were comprised of the following:

| (in thousands) | December 31, | |
|-----------------------------------|--------------|------------|
| | 2008 | 2007 |
| Construction and land development | \$ 63,361 | \$ 69,803 |
| Commercial real estate | 207,160 | 198,332 |
| Residential real estate | 136,480 | 133,899 |
| Home equity | 57,170 | 48,313 |
| Total real estate | 464,171 | 450,347 |
| Commercial and industrial | 98,546 | 91,028 |
| Consumer | 8,393 | 10,016 |
| Total loans | \$ 571,110 | \$ 551,391 |

Net deferred loan costs included in the above loan categories are \$244,000 for 2008 and \$171,000 for 2007.

The following is a summary of information pertaining to impaired and nonaccrual loans:

| (in thousands) | December 31, | |
|---|--------------|----------|
| | 2008 | 2007 |
| Impaired loans with a valuation allowance | \$ 2,545 | \$ 3,092 |
| Impaired loans without a valuation allowance | 647 | 473 |
| Total impaired loans | \$ 3,192 | \$ 3,565 |
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ 1,164 | \$ 1,499 |

| | | | | |
|--|----|-------|----|-------|
| Nonaccrual loans excluded from the impaired loan disclosure | \$ | 1,574 | \$ | 1,329 |
|--|----|-------|----|-------|

| (in thousands) | Years Ended December 31, | | | | | |
|---|--------------------------|-------|------|-------|----|-------|
| | 2008 | 2007 | 2006 | | | |
| Average balance in impaired loans | \$ | 4,829 | \$ | 2,540 | \$ | 2,534 |
| Interest income recognized on impaired loans | \$ | 152 | \$ | 262 | \$ | 121 |
| Interest income recognized on nonaccrual loans | \$ | - | \$ | - | \$ | - |
| Loans past due 90 days and still accruing interest | \$ | - | \$ | - | \$ | - |

No additional funds are committed to be advanced in connection with impaired loans.

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Note 5 – Accounting for Certain Loans Acquired in a Transfer

The Company acquired loans pursuant to the acquisition of Community First Financial Corporation (“Community First”) in April 2006. In accordance with SOP 03-3, at acquisition the Company reviewed each loan to determine whether there was evidence of deterioration of credit quality since origination and if it was probable that it will be unable to collect all amounts due according to the loan’s contractual terms. When both conditions existed, the Company accounted for each loan individually, considered expected prepayments, and estimated the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan. The Company determined the excess of the loan’s scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount, representing the excess of the loan’s cash flows expected to be collected over the amount paid, is accreted into interest income over the remaining life of the loan (accretable yield).

Over the life of the loan, the Company continues to estimate cash flows expected to be collected. The Company evaluates at the balance sheet date whether the present value of its loans determined using the effective interest rates has decreased and if so, establishes a valuation allowance for the loan. Valuation allowances for acquired loans subject to SOP 03-3 reflect only those losses incurred after acquisition – that is, the present value of cash flows expected at acquisition that are not expected to be collected. Valuation allowances are established only subsequent to acquisition of the loans. For loans that are not accounted for as debt securities, the present value of any subsequent increase in the loan’s or pool’s actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan. For any remaining increases in cash flows expected to be collected, the Company adjusts the amount of accretable yield recognized on a prospective basis over the loan’s remaining life. The Company does not have any such loans that were accounted for as debt securities.

Loans that were acquired in the Community First acquisition, for which there was evidence of deterioration of credit quality since origination and for which it was probable that all contractually required payments would not be made had an outstanding balance of \$665,000 and a carrying amount \$344,000 at December 31, 2008 and an outstanding balance of \$1,010,000 and a carrying amount of \$582,000 at December 31, 2007.

The carrying amount of these loans is included in the balance sheet amount of loans receivable at December 31, 2008 and 2007. These loans are not included in the impaired loan amounts disclosed in Note 4.

| (in thousands) | Accretable Yield |
|--|---------------------|
| Balance at December 31, 2006 | \$ 692 |
| Accretion | (52) |
| Reclassifications from nonaccretable difference | 1 |
| Disposals | (530) |
| Balance at December 31, 2007 | 111 |
| Accretion | (20) |
| Disposals | (46) |

Balance at
December 31,
2008 \$ 45

54

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Note 6 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for each of the years in the three-year period ended December 31, 2008, are presented below:

| (in thousands) | Years Ended December 31, | | |
|------------------------------|--------------------------|----------|----------|
| | 2008 | 2007 | 2006 |
| Allowance for Loan Losses | | | |
| Balance, beginning of year | \$ 7,395 | \$ 7,264 | \$ 6,109 |
| Allowance acquired in merger | - | - | 1,598 |
| Provision for loan losses | 1,620 | 403 | 58 |
| Charge-offs | (1,564) | (515) | (913) |
| Recoveries | 373 | 243 | 412 |
| Balance, end of year | \$ 7,824 | \$ 7,395 | \$ 7,264 |

| | Years Ended December 31, | | |
|--|--------------------------|--------|--------|
| | 2008 | 2007 | 2006 |
| Reserve for Unfunded Lending Commitments | | | |
| Balance, beginning of year | \$ 151 | \$ 123 | \$ - |
| Provision for unfunded commitments | 324 | 28 | 123 |
| Balance, end of year | \$ 475 | \$ 151 | \$ 123 |

The reserve for unfunded loan commitments is included in other liabilities.

Note 7 – Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

| (in thousands) | December 31, | |
|-----------------------------|--------------|-----------|
| | 2008 | 2007 |
| Land | \$ 3,977 | \$ 3,977 |
| Buildings | 15,686 | 11,573 |
| Leasehold improvements | 535 | 492 |
| Furniture and equipment | 14,383 | 13,210 |
| | 34,581 | 29,252 |
| Accumulated depreciation | (17,150) | (15,904) |
| Premises and equipment, net | \$ 17,431 | \$ 13,348 |

Depreciation expense for the years ended December 31, 2008, 2007, and 2006 was \$1,358,000, \$1,178,000 and \$993,000, respectively.

The Company has entered into operating leases for several of its branch and ATM facilities. The minimum annual rental payments under these leases at December 31, 2008 are as follows:

| (in thousands) Year | Minimum Lease Payments |
|------------------------|------------------------------|
| 2009 | \$ 296 |
| 2010 | 228 |
| 2011 | 97 |
| 2012 | 58 |
| 2013 | 21 |
| 2014 and after | 2 |
| | \$ 702 |

Rent expense for the years ended December 31, 2008, 2007, and 2006 was \$329,000, \$353,000, and \$308,000, respectively.

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Note 8– Goodwill and Other Intangible Assets

In January 2002, the Company adopted SFAS 142, Goodwill and Other Intangible Assets. Accordingly, goodwill is no longer subject to amortization, but is subject to at least an annual assessment for impairment by applying a fair value test. A fair value-based test was performed during the third quarter of 2008 that determined the market value of the Company's shares exceeds the consolidated carrying value, including goodwill; therefore, there has been no impairment recognized in the value of goodwill.

The changes in the carrying amount of goodwill for the year ended December 31, 2008, are as follows (in thousands):

| | Amount |
|---------------------------------|-----------|
| Balance as of January 1, 2008 | \$ 22,468 |
| Goodwill recorded during year | - |
| Impairment losses | - |
| Balance as of December 31, 2008 | \$ 22,468 |

Core deposit intangibles resulting from the Community First acquisition in April 2006 were \$3,112,000 and are being amortized over 99 months.

Goodwill and intangible assets are as follow (in thousands):

| | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
|--------------------------------------|----------------------------|-----------------------------|--------------------------|
| December 31, 2008 | | | |
| Amortizable core deposit intangibles | \$ 3,112 | \$ 1,037 | \$ 2,075 |
| Goodwill | 22,468 | - | 22,468 |
| December 31, 2007 | | | |
| Amortizable core deposit intangibles | \$ 3,112 | \$ 660 | \$ 2,452 |
| Goodwill | 22,468 | - | 22,468 |

Amortization expense of core deposit intangibles for the years ended December 31, 2008, 2007, and 2006 totaled \$377,000, \$377,000, and \$414,000, respectively. As of December 31, 2008, the estimated future amortization expense of core deposit intangibles is as follows (in thousands):

| Year | Amount |
|------------|--------|
| 2009 | \$ 377 |
| 2010 | 377 |
| 2011 | 377 |
| 2012 | 377 |
| 2013 | 377 |
| Thereafter | 190 |

Note 9 - Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2008 and 2007 was \$107,186,000 and \$101,212,000 respectively.

At December 31, 2008, the scheduled maturities of certificates of deposits (included in “time” deposits on the Consolidated Balance Sheet) were as follows (in thousands):

| Year | Amount |
|------|------------|
| 2009 | \$ 181,352 |
| 2010 | 34,780 |
| 2011 | 15,093 |
| 2012 | 10,878 |
| 2013 | 18,961 |
| | \$ 261,064 |

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Note 10 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the Federal Home Loan Bank of Atlanta (“FHLB”), and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company’s control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following as of December 31, 2008 and 2007 (in thousands):

| | 2008 | 2007 |
|--------------------------------|-----------|-----------|
| Customer repurchase agreements | \$ 51,741 | \$ 47,891 |
| FHLB overnight borrowings | 7,850 | 7,200 |
| | \$ 59,591 | \$ 55,091 |

Note 11 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company’s assets, subject to the amount of collateral pledged. As of December 31, 2008, \$107,834,000 in 1-4 family residential mortgage loans and \$57,170,000 in home equity lines of credit were pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of December 31, 2008 and 2007 (in thousands):

| Due by December 31 | 2008 Advance Amount | Weighted Average Rate | Due by December 31 | 2007 Advance Amount | Weighted Average Rate |
|--------------------------|---------------------------|-----------------------------|--------------------------|---------------------------|-----------------------------|
| 2009 | \$ 5,000 | 5.26% | 2008 | \$ 3,000 | 5.51% |
| | 8,000 | 2.93 | 2009 | 5,000 | 5.26 |
| | 787 | 3.78 | 2014 | 937 | 3.78 |
| | \$ 13,787 | 3.82% | | \$ 8,937 | 5.19% |

Note 12 – Trust Preferred Capital Notes

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a newly formed, wholly owned subsidiary of the Company, issued \$20,000,000 of preferred securities in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company’s option beginning on June 30, 2011. The securities require quarterly distributions by the Trust to the holder

of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate will reset quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to twenty consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of \$619,000 received by the Trust from the issuance of common securities by the Trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a Junior Subordinated Indenture entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company, and for general corporate purposes. In accordance with FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, the Corporation did not eliminate through consolidation the Corporation's \$619,000 equity investment in AMNB Statutory Trust I. Instead, the Corporation reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

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Note 13 – Stock-Based Compensation

The Company's 1997 Stock Option Plan ("1997 Option Plan") provided for the granting of incentive and non-statutory options to employees on a periodic basis, at the discretion of the Board or a Board designated committee. The 1997 Option Plan authorized the issuance of up to 300,000 shares of common stock. There were no options granted since 2004, and, effective December 31, 2006, no further options may be granted under this plan.

Effective January 1, 2006, the Company adopted SFAS 123R, Share Based Payment, using the modified prospective method and as such, results for prior periods have not been restated. All options under the 1997 Option Plan were fully vested prior to January 1, 2006; therefore, adoption of SFAS 123R resulted in no compensation expense. There was no tax benefit associated with stock option activity during 2008, 2007, or 2006. Under SFAS 123R, a company may only recognize tax benefits for stock options that ordinarily will result in a tax deduction when the option is exercised ("non-statutory" options). The Company has no non-statutory stock options.

The 2008 Stock Incentive Plan ("2008 Option Plan") was adopted by the Board of Directors of the Company on February 19, 2008 and approved by the stockholders on April 22, 2008. The 2008 Option Plan provides for the granting of restricted stock awards and incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board or a Board designated committee. The 2008 Option Plan authorized the issuance of up to 500,000 shares of common stock. SFAS 123(R) requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued. For the year ended December 31, 2008, the Company recognized \$59,000 in compensation expense for stock options.

A summary of stock option transactions is as follows:

| | Option Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (\$000) |
|-------------------------------------|------------------|--|---|--|
| Outstanding at December 31, 2007 | 174,871 | \$ 21.15 | | |
| Granted | 59,000 | 17.00 | | |
| Exercised | (13,061) | 16.83 | | |
| Forfeited | (2,200) | 18.86 | | |
| Outstanding at December 31, 2008 | 218,610 | \$ 20.31 | 5.4 years | \$ 91 |
| Exercisable at December 31, 2008 | 174,360 | \$ 21.15 | 4.2 years | \$ 91 |

The aggregate intrinsic value of stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount changes based on changes in the market value of the Company's stock.

The total proceeds of the in-the-money options exercised during the year ended December 31, 2008 and 2007 was \$219,000 and \$295,000, respectively. Total intrinsic value of options exercised during years ended December 31, 2008, 2007, and 2006 was \$51,000, \$110,000, and \$114,000, respectively.

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As of December 31, 2008, there was \$176,000 unrecognized compensation expense. There was no unrecognized compensation expense as of December 31, 2007. Compensation expense related to stock options was \$59,000 in 2008, \$0 in 2007 and 2006.

The following table summarizes information related to stock options outstanding on December 31, 2008:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|--------------------------|-------------------------------|---|---------------------------------|-------------------------------|---------------------------------|--|
| | Number of Outstanding Options | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Number of Options Exercisable | Weighted-Average Exercise Price | |
| \$ 13.38 to 15.00 | 25,789 | 0.3 yrs | \$ 13.69 | 25,789 | \$ 13.69 | |
| 15.01 to 20.00 | 99,794 | 6.7 | 17.64 | 55,544 | 18.15 | |
| 20.01 to 25.00 | 54,400 | 5.8 | 24.18 | 54,400 | 24.18 | |
| 25.01 to 26.20 | 38,627 | 4.8 | 26.18 | 38,627 | 26.18 | |
| | 218,610 | 5.4 yrs | \$ 20.31 | 174,360 | \$ 21.15 | |

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The fair value of each stock option granted in 2008 was estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table for the year ended December 31, 2008.

| | 2008 |
|--|--------|
| Dividend yield | 5.41% |
| Expected life in years | 6.6 |
| Expected volatility | 18.10% |
| Risk-free interest rate | 1.77% |
| Weighted average fair value per option granted | \$3.98 |

The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Company's history and expectation of dividend payouts.

Note 14 – Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the states of Virginia and North Carolina. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2005.

The Company adopted the provisions of FIN 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007, with no impact on the consolidated financial statements.

The components of the Company's net deferred tax assets were as follows:

| (in thousands) | December 31, | |
|--|--------------|--------------|
| | 2008 | 2007 |
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 2,675 | \$ 2,476 |
| Accrued pension benefit | - | 243 |
| Nonaccrual loan interest | 165 | 175 |
| Deferred compensation | 211 | 217 |
| Preferred stock impairment, net of valuation allowance | - | 294 |
| Allowance for off balance sheet items | 166 | - |
| Loans | 373 | 607 |
| Other | 50 | 7 |
| Total deferred tax assets | 3,640 | 4,019 |
| Deferred tax liabilities: | | |
| Depreciation | 1,005 | 806 |
| Accretion of discounts on securities | 33 | 33 |
| Core deposit intangibles | 508 | 535 |
| Deferred loan fees | 86 | 60 |
| Net unrealized gains on securities | 1,090 | 574 |
| Prepaid pension expense | 240 | - |

| | | |
|---------------------------------------|------------|----------|
| Pension liability | 1,826 | 812 |
| Other | 52 | 178 |
| Total deferred tax liabilities | 4,840 | 2,998 |
| Net deferred tax assets (liabilities) | \$ (1,200) | \$ 1,021 |

The provision for income taxes consists of the following:

| (in thousands) | Years Ended December 31, | | |
|-----------------------------------|--------------------------|----------|----------|
| | 2008 | 2007 | 2006 |
| Taxes currently payable | \$ 2,490 | \$ 4,943 | \$ 4,387 |
| Deferred tax expense (benefit) | 691 | (67) | 732 |
| | \$ 3,181 | \$ 4,876 | \$ 5,119 |

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The effective tax rates differ from the statutory federal income tax rates due to the following items:

| | Years Ended December 31, | | |
|----------------------------|--------------------------|-------|-------|
| | 2008 | 2007 | 2006 |
| Federal statutory rate | 34.1% | 34.4% | 34.4% |
| Nontaxable interest income | (4.9) | (3.5) | (3.7) |
| Other | 0.8 | (1.0) | 0.2 |
| Effective rate | 28.4% | 29.9% | 30.9% |

Note 15 – Earnings Per Share

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

| | Years Ended December 31, | | | | | |
|---------------------------------|--------------------------|------------------|-----------|------------------|-----------|------------------|
| | 2008 | | 2007 | | 2006 | |
| | Shares | Per Share Amount | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic earnings per share | 6,096,649 | \$ 1.32 | 6,139,095 | \$ 1.86 | 5,986,262 | \$ 1.91 |
| Effect of dilutive securities - | | | | | | |
| stock options | 8,505 | (.01) | 22,730 | - | 33,809 | (.01) |
| Diluted earnings per share | 6,105,154 | \$ 1.31 | 6,161,825 | \$ 1.86 | 6,020,071 | \$ 1.90 |

Stock options on common stock which were not included in computing diluted EPS in 2008, 2007, and 2006, because their effects were antidilutive averaged 118,640 shares, 89,277 shares, and 88,177 shares, respectively.

Note 16 – Off-Balance Sheet Activities

The Company is party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if applicable, is based on management's credit evaluation of the customer.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

The following off-balance sheet financial instruments were outstanding whose contract amounts represent credit risk:

December 31,

| (in thousands) | 2008 | 2007 |
|-------------------------------------|------------|------------|
| Commitments to extend credit | \$ 146,399 | \$ 144,301 |
| Standby letters of credit | 2,858 | 6,222 |
| Mortgage loan rate lock commitments | 2,031 | 2,215 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally consist of unused portions of lines of credit issued to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

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At December 31, 2008, the Company had entered into commitments, on a best-effort basis, to sell loans of approximately \$3,787,000. These commitments include mortgage loan commitments and loans held for sale. Risks arise from the possible inability of counterparties to meet the terms of their contracts.

Note 17 – Related Party Loans

In the ordinary course of business, loans are granted to executive officers, directors, and their related entities. Management believes that all such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to similar, unrelated borrowers, and do not involve more than a normal risk of collectability or present other unfavorable features. As of December 31, 2008, none of these loans were restructured, past due, or on nonaccrual status.

An analysis of these loans for 2008 is as follows (in thousands):

| | |
|------------------------------|-----------|
| Balance at December 31, 2007 | \$ 20,282 |
| Additions | 22,216 |
| Repayments | (22,703) |
| Balance at December 31, 2008 | \$ 19,795 |

Note 18 – Employee Benefit Plans

Defined Benefit Plan

The Company maintains a non-contributory defined benefit pension plan which covers substantially all employees who are 21 years of age or older and who have had at least one year of service. Advanced funding is accomplished by using the actuarial cost method known as the collective aggregate cost method. Prior to 2008, the Company used October 31 as a measurement date to determine postretirement benefit obligations. The requirement under SFAS 158 to measure plan assets and benefit obligations as of the date of the employers' fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008.

The following table sets forth the plan's status and related disclosures as required by SFAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106, and 132(R):

| (in thousands) | As of and for the Years Ended December 31, | | |
|---|--|----------|----------|
| | 2008 | 2007 | 2006 |
| Change in Benefit Obligation: | | | |
| Projected benefit obligation at beginning of year | \$ 8,923 | \$ 7,038 | \$ 7,225 |
| Service cost | 843 | 656 | 621 |
| Interest cost | 600 | 418 | 351 |
| Plan amendments | - | - | 101 |
| Actuarial loss (gain) | (627) | 987 | 6 |
| Benefits paid | (157) | (176) | (1,266) |
| Projected benefit obligation at end of year | 9,582 | 8,923 | 7,038 |
| Change in Plan Assets: | | | |

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| | | | |
|--|----------|----------|----------|
| Fair value of plan assets at beginning of year | 8,230 | 7,070 | 6,056 |
| Actual return on plan assets | (2,888) | 1,336 | 780 |
| Employer contributions | 5,000 | - | 1,500 |
| Benefits paid | (158) | (176) | (1,266) |
| Fair value of plan assets at end of year | 10,184 | 8,230 | 7,070 |
| Funded Status at End of Year | \$ 602 | \$ (693) | \$ 32 |
| Amounts Recognized in the Consolidated Balance Sheets | | | |
| Other assets (liabilities) | \$ 602 | \$ (693) | \$ 32 |
| Amounts Recognized in Accumulated Other Comprehensive Income | | | |
| Net actuarial loss | \$ 5,205 | \$ 2,308 | \$ 2,243 |
| Prior service cost | 13 | 12 | 11 |
| Deferred income tax benefit | (1,827) | (812) | (789) |
| Amount recognized | \$ 3,391 | \$ 1,508 | \$ 1,465 |

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| (in thousands) | As of and for the Years Ended December 31, | | |
|---|--|--------|--------|
| | 2008 | 2007 | 2006 |
| Components of Net Periodic Benefit Cost | | | |
| Service cost | \$ 723 | \$ 656 | \$ 621 |
| Interest cost | 515 | 418 | 351 |
| Expected return on plan assets | (657) | (564) | (521) |
| Amortization of prior service cost | (1) | (1) | (23) |
| Recognized net actuarial loss | 112 | 150 | 211 |
| Net periodic benefit cost | \$ 692 | \$ 659 | \$ 639 |

Adjustment to Retained Earnings Due to
Change in Measurement Date

| | | | |
|--------------------------------|--------|-----|-----|
| Service cost | \$ 121 | N/A | N/A |
| Interest cost | 86 | N/A | N/A |
| Expected return on plan assets | (110) | N/A | N/A |
| Recognized net actuarial loss | 18 | N/A | N/A |
| Net periodic benefit cost | \$ 115 | N/A | N/A |

Other Changes in Plan Assets and Benefit
Obligations Recognized in Other Comprehensive
Income

| | | | |
|--|----------|-------|----------|
| Net actuarial loss | \$ 2,897 | \$ 65 | \$ 2,243 |
| Prior service cost | - | - | 11 |
| Amortization of prior service cost | 1 | 1 | - |
| Total recognized in other comprehensive income | \$ 2,898 | \$ 66 | \$ 2,254 |

Total Recognized in Net Periodic Benefit Cost,
Retained Earnings and Other Comprehensive
Income

| | | | |
|--|----------|--------|----------|
| | \$ 3,705 | \$ 725 | \$ 2,893 |
|--|----------|--------|----------|

Weighted-Average Assumptions at End of Year

| | | | |
|--|-------|-------|-------|
| Discount rate used for net periodic pension cost | 6.00% | 6.00% | 5.75% |
| Discount rate used for disclosure | 6.00% | 6.00% | 6.00% |
| Expected return on plan assets | 8.00% | 8.00% | 8.00% |
| Rate of compensation increase | 4.00% | 4.00% | 4.00% |

N/A – not applicable

The accumulated benefit obligation as of December 31, 2008, 2007, and 2006 was \$6,942,364, \$6,499,448, and \$4,971,000 respectively.

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust,

and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period in which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

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Below is a description of the plan's assets. The plan's weighted-average asset allocations by asset category are as follows:

| Asset Category | December 31, 2008 | October 31, 2007 |
|-------------------------|----------------------|---------------------|
| Fixed Income | 24.8% | 25.0% |
| Equity | 34.0 | 63.7 |
| Mutual Funds | 5.5 | - |
| Cash and Accrued Income | 35.7 | - |
| Other | - | 11.3 |
| Total | 100.0% | 100.0% |

The investment policy and strategy for plan assets can best be described as a growth and income strategy. Diversification is accomplished by limiting the holding of any one equity issuer to no more than 5% of total equities. Exchange traded funds are used to provide diversified exposure to the small capitalization and international equity markets. All fixed income investments are rated as investment grade, with the majority of these assets invested in corporate issues. The assets are managed by the Company's Trust and Investment Services Division. No derivatives are used to manage the assets. Equity securities do not include holdings in the Company.

Projected benefit payments for the years 2009 to 2018 are as follows (in thousands):

| Year | Amount |
|-----------|--------|
| 2009 | \$ 57 |
| 2010 | 85 |
| 2011 | 204 |
| 2012 | 248 |
| 2013 | 290 |
| 2014-2018 | 2,224 |

The Company does not anticipate making a contribution in 2009.

Defined Contribution Plan

The Company maintains a 401(k) savings plan that covers substantially all full-time employees of the Company. The Company matches a portion of the contribution made by employee participants after at least one year of service. The Company contributed \$263,000, \$273,000, and \$245,000 to the 401(k) plan in 2008, 2007, and 2006, respectively. These amounts are included employee benefits expense for the respective years.

Deferred Compensation Arrangements

The Company maintains deferred compensation agreements with certain current and former employees providing for annual payments to each ranging from \$25,000 to \$50,000 per year for ten years upon their retirement. The liabilities under these agreements are being accrued over the officers' remaining periods of employment so that, on the date of their retirement, the then-present value of the annual payments would have been accrued. The expense for these agreements was \$33,000, \$55,000, and \$60,000 for years 2008, 2007, and 2006, respectively.

Profit Sharing and Incentive Arrangements

The Company maintains a cash profit sharing plan for full-time employees based on the Company's performance and a cash incentive compensation plan for officers based on the Company's performance and individual officer goals. The total amount charged to salary expense for these plans was \$0, \$287,000, and \$867,000 for the years 2008, 2007, and 2006, respectively.

Note 19 – Fair Value of Financial Instruments

The Company adopted SFAS No. 157, Fair Value Measurements ("SFAS 157"), on January 1, 2008 to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. SFAS 157 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

In February 2008, the FASB issued Staff Position No. 157-2 ("FSP 157-2") which delayed the effective date of SFAS 157 for certain nonfinancial assets and nonfinancial liabilities except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-2 defers the effective date of SFAS 157 for such nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Thus, the Company has only partially applied SFAS 157. Those items affected by FSP 157-2 include other real estate owned (OREO), goodwill and core deposit intangibles.

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In October of 2008, the FASB issued Staff Position No. 157-3 (“FSP 157-3”) to clarify the application of SFAS 157 in a market that is not active and to provide key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements were not issued.

SFAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company’s market assumptions. The three levels of the fair value hierarchy under SFAS 157 based on these two types of inputs are as follows:

Level 1 –Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 –Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 –Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2). Federal Reserve Bank and Federal Home Loan Bank stocks are carried at cost since no ready market exists and there is no quoted market value. The Company is required to own stock in these companies as long as it is a member. Therefore, they have been excluded from the table below.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 (in thousands):

| Description | Balance as of December 31, 2008 | Fair Value Measurements at December 31, 2008 Using | | |
|-------------------------------|---------------------------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Assets | | | | |
| Securities available for sale | \$ 129,904 | \$ - | \$ 129,904 | \$ - |
| | 9 | - | 9 | - |

Mortgage loan derivative
contracts

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2008. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

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Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the period (in thousands):

| Description | Carrying Value at December 31, 2008 | | | |
|--|-------------------------------------|--|---|---|
| | Balance as of December 31, 2008 | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Assets | | | | |
| Loans held for sale | \$ 1,764 | \$ - | \$ 1,764 | \$ - |
| Impaired loans, net of valuation allowance | 1,381 | - | 600 | 781 |

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. SFAS 107, Disclosures About Fair Value of Financial Instruments, excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The estimated fair values of the Company's assets are as follows:

| (in thousands) | December 31, 2008 | | December 31, 2007 | |
|-------------------|-------------------|----------------------|-------------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |

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| | | | | |
|---------------------------------|------------|------------|------------|------------|
| Cash and due from banks | \$ 24,098 | \$ 24,098 | \$ 18,304 | \$ 18,304 |
| Securities available for sale * | 129,904 | 129,904 | 141,605 | 141,605 |
| Securities held to maturity | 7,121 | 7,391 | 11,990 | 12,250 |
| Loans held for sale | 1,764 | 1,764 | 1,368 | 1,368 |
| Loans, net of allowance | 563,286 | 575,970 | 543,996 | 550,458 |
| Accrued interest receivable | 3,110 | 3,110 | 3,547 | 3,547 |
| Financial liabilities: | | | | |
| Deposits | \$ 589,138 | \$ 591,159 | \$ 581,221 | \$ 581,726 |
| Repurchase agreements | 51,741 | 51,741 | 47,891 | 47,891 |
| Other borrowings | 21,637 | 21,630 | 16,137 | 15,850 |
| Trust preferred capital notes | 20,619 | 18,258 | 20,619 | 20,155 |
| Accrued interest payable | 1,272 | 1,272 | 1,722 | 1,722 |

* - Excludes restricted stock

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

Cash and cash equivalents. The carrying amount is a reasonable estimate of fair value.

Securities. Fair values are based on quoted market prices or dealer quotes. The carrying value of restricted stock approximates fair value.

Loans held for sale. The carrying amount is a reasonable estimate of fair value.

Loans. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated based upon discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Accrued interest receivable. The carrying amount is a reasonable estimate of fair value.

Deposits. The fair value of demand deposits, savings deposits, and money market deposits equals the carrying value. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposit instruments would be offered to depositors for the same remaining maturities.

Repurchase agreements. The carrying amount is a reasonable estimate of fair value.

Other borrowings. The fair values of long-term borrowings are estimated using discounted cash flow analyses based on the interest rates for similar types of borrowing arrangements.

Trust preferred capital notes. Fair value is calculated by discounting the future cash flows using the estimated current interest rates at which similar securities would be issued.

Accrued interest payable. The carrying amount is a reasonable estimate of fair value.

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2008 and 2007, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the table above. The various off-balance sheet instruments were discussed in Note 16.

The Company assumes interest rate risk (the risk that interest rates will change) in its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rates change and that change may be either favorable or unfavorable to the Company.

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Note 20 – Dividend Restrictions and Regulatory Capital

The approval of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the bank's net income, as defined, for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Company's bank subsidiary can distribute as dividends to American National Bankshares Inc., without the approval of the Comptroller of the Currency, \$1,784,000 as of December 31, 2008.

The Company (on a consolidated basis) and its bank subsidiary are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are subject to qualitative judgments by the regulators concerning components, risk weighting, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under the guidelines, total capital is defined as core (Tier I) capital and supplementary (Tier II) capital. The Company's Tier I capital consists primarily of shareholders' equity and trust preferred capital notes, while Tier II capital also includes the allowance for loan losses subject to certain limits. The definition of assets has been modified to include items on and off the balance sheet, with each item being assigned a "risk-weight" for the determination of the ratio of capital to risk-adjusted assets. Management believes, as of December 31, 2008 and 2007, that the Company met the requirements to be considered "well capitalized."

The following table provides summary information regarding regulatory capital:

| (in thousands) | Actual | | Minimum Capital Requirement | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|-------------------|------------|--------|-----------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2008 | | | | | | |
| Total Capital | | | | | | |
| Company | \$ 106,573 | 17.92% | \$ 47,576 | >8.0% | | |
| Bank | 91,686 | 15.42 | 47,565 | >8.0 | \$ 59,457 | >10.0% |
| Tier I Capital | | | | | | |
| Company | 99,124 | 16.67 | 23,788 | >4.0 | | |
| Bank | 85,144 | 14.32 | 23,783 | >4.0 | 35,674 | >6.0 |
| Leverage Capital | | | | | | |
| Company | 99,124 | 13.04 | 30,408 | >4.0 | | |
| Bank | 85,144 | 11.23 | 30,333 | >4.0 | 37,916 | >5.0 |

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December 31,
2007

Total Capital

| | | | | | | |
|---------|------------|--------|-----------|-------|-----------|--------|
| Company | \$ 104,179 | 18.28% | \$ 45,593 | >8.0% | | |
| Bank | 93,961 | 16.49 | 45,581 | >8.0 | \$ 56,976 | >10.0% |

Tier I Capital

| | | | | | | |
|---------|--------|-------|--------|------|--------|------|
| Company | 97,033 | 17.03 | 22,797 | >4.0 | | |
| Bank | 87,806 | 15.41 | 22,791 | >4.0 | 34,186 | >6.0 |

Leverage
Capital

| | | | | | | |
|---------|--------|-------|--------|------|--------|------|
| Company | 97,033 | 12.98 | 29,912 | >4.0 | | |
| Bank | 87,806 | 11.76 | 29,862 | >4.0 | 37,328 | >5.0 |

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Note 21 – Segment and Related Information

In accordance with SFAS 131, Disclosures About Segments of an Enterprise and Related Information, reportable segments include community banking and trust and investment services.

Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Company are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts, and non-deposit fees such as automated teller machine fees and insurance commissions generate additional income for community banking.

Trust and investment services include estate planning, trust account administration, investment management, and retail brokerage. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services division receives fees for investment and administrative services.

Amounts shown in the “Other” column includes activities of American National Bankshares Inc. The “Other” column also includes corporate items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to reportable segments. Intersegment eliminations primarily consist of American National Bankshares Inc.’s investment in American National Bank and Trust Company and related equity earnings.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. All intersegment sales prices are market based.

Segment information as of and for the years ended December 31, 2008, 2007, and 2006, is shown in the following table:

| (in thousands) | 2008 | | | | | Total |
|---|-------------------|-------------------------------|---------|---------------------------|-----------|-------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | | |
| Interest income | \$ 42,836 | \$ - | \$ 129 | \$ (93) | \$ 42,872 | |
| Interest expense | 14,559 | - | 1,373 | (93) | 15,839 | |
| Noninterest income - external customers | 3,957 | 3,899 | 57 | - | 7,913 | |
| Operating income before income taxes | 10,951 | 1,791 | (1,540) | - | 11,202 | |
| Depreciation and amortization | 1,710 | 23 | 2 | - | 1,735 | |
| Total assets | 788,435 | - | 749 | - | 789,184 | |
| Capital expenditures | 5,423 | 25 | - | - | 5,448 | |

| (in thousands) | 2007 | | | | | Total |
|------------------|-------------------|-------------------------------|-------|---------------------------|-----------|-------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | | |
| Interest income | \$ 48,597 | \$ - | \$ - | \$ - | \$ 48,597 | |
| Interest expense | 17,997 | - | 1,373 | - | 19,370 | |
| | 4,623 | 4,128 | 71 | - | 8,822 | |

| | | | | | |
|---|---------|-------|---------|---|---------|
| Noninterest income - external customers | | | | | |
| Operating income before income taxes | 15,615 | 2,234 | (1,529) | - | 16,320 |
| Depreciation and amortization | 1,528 | 25 | 2 | - | 1,555 |
| Total assets | 771,518 | - | 770 | - | 772,288 |
| Capital expenditures | 2,087 | 18 | - | - | 2,105 |

| | 2006 | | | | |
|---|-------------------|-------------------------------|---------|---------------------------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 45,060 | \$ - | \$ 10 | \$ - | \$ 45,070 |
| Interest expense | 15,629 | - | 1,032 | - | 16,661 |
| Noninterest income - external customers | 4,623 | 3,793 | 42 | - | 8,458 |
| Operating income before income taxes | 15,747 | 1,963 | (1,165) | - | 16,545 |
| Depreciation and amortization | 1,383 | 22 | 2 | - | 1,407 |
| Total assets | 777,001 | - | 719 | - | 777,720 |
| Capital expenditures | 1,044 | 1 | - | - | 1,045 |

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Note 22 – Parent Company Financial Information

Condensed Parent Company financial information is as follows (in thousands):

| Condensed Balance Sheets | December 31, | |
|--|--------------|------------|
| | 2008 | 2007 |
| Cash | \$ 13,356 | \$ 8,619 |
| Investment in subsidiaries | 108,320 | 112,903 |
| Other assets | 1,311 | 671 |
| Total Assets | \$ 122,987 | \$ 122,193 |
| Trust preferred capital notes | \$ 20,619 | \$ 20,619 |
| Other liabilities | 68 | 63 |
| Shareholders' equity | 102,300 | 101,511 |
| Total Liabilities and Shareholders' Equity | \$ 122,987 | \$ 122,193 |

| Condensed Statements of Income | Years Ended December 31, | | |
|--|--------------------------|-----------|-----------|
| | 2008 | 2007 | 2006 |
| Dividends from subsidiary | \$ 12,000 | \$ 12,000 | \$ 7,900 |
| Other income | 150 | 86 | 52 |
| Expenses | 1,689 | 1,615 | 1,217 |
| Income taxes (benefit) | (523) | (520) | (396) |
| Income before equity in undistributed earnings of subsidiary | 10,984 | 10,991 | 7,131 |
| Equity (deficit) in undistributed earnings of subsidiary | (2,963) | 453 | 4,295 |
| Net Income | \$ 8,021 | \$ 11,444 | \$ 11,426 |

| Condensed Statements of Cash Flows | Years Ended December 31, | | |
|---|--------------------------|-----------|----------|
| | 2008 | 2007 | 2006 |
| Cash provided by dividends received from subsidiary | \$ 12,000 | \$ 12,000 | \$ 7,900 |
| Cash used for payment of dividends | (5,606) | (5,587) | (5,210) |
| Cash used for repurchase of stock | (904) | (1,359) | (912) |
| Proceeds from exercise of options | 219 | 295 | 171 |
| Other | (972) | (1,182) | 1,535 |
| Net increase in cash | \$ 4,737 | \$ 4,167 | \$ 3,484 |

Note 23 – Concentrations of Credit Risk

Substantially all the Company's loans are made within its market area, which includes Southern and Central Virginia and the northern portion of Central North Carolina. The ultimate collectability of the Company's loan portfolio and the ability to realize the value of any underlying collateral, if necessary, are impacted by the economic conditions of the market area.

Loans secured by real estate were \$464,171,000, or 81% of the loan portfolio, at December 31, 2008, and \$450,347,000, or 82% of the loan portfolio, at December 31, 2007. Loans secured by commercial real estate represented the largest portion of loans at \$207,160,000 at December 31, 2008, and \$198,332,000 at December 31, 2007, 36% and 36%, respectively of total loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2008 or 2007, loans to lessors of nonresidential buildings represented 13.7% of total loans at December 31, 2008 and 11.0% at December 31, 2007; the lessees and lessors are engaged in a variety of industries.

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Note 24 – Supplemental Cash Flow Information

| (Dollars in thousands) | For the Years ended December 31, | | |
|--|----------------------------------|-----------|-----------|
| | 2008 | 2007 | 2006 |
| Supplemental Schedule of Cash and Cash Equivalents: | | | |
| Cash and due from banks | \$ 14,986 | \$ 18,155 | \$ 24,375 |
| Interest-bearing deposits in other banks | 9,112 | 149 | 1,749 |
| | \$ 24,098 | \$ 18,304 | \$ 26,124 |
| Supplemental Disclosure of Cash Flow Information: | | | |
| Cash paid for: | | | |
| Interest on deposits and borrowed funds | \$ 16,289 | \$ 19,332 | \$ 14,906 |
| Income taxes | 2,936 | 3,790 | 3,738 |
| Noncash investing and financing activities: | | | |
| Transfer of loans to other real estate owned | 4,060 | 498 | 115 |
| Unrealized gain (loss) on securities available for sale | 1,474 | 2,723 | 8 |
| Change in unfunded pension liability | 2,898 | 66 | - |
| Transactions related to the merger acquisition: | | | |
| Increase in assets and liabilities | | | |
| Cash and due from banks | \$ - | \$ - | \$ 2,956 |
| Securities | - | - | 8,020 |
| Loans, net | - | - | 134,217 |
| Premises and equipment, net | - | - | 4,930 |
| Goodwill and core deposit intangibles | - | - | 25,580 |
| Accrued interest receivable and other assets | - | - | 5,481 |
| Demand deposits--noninterest bearing | - | - | 21,376 |
| Demand deposits--interest bearing | - | - | 120,596 |
| Borrowings | - | - | 2,500 |
| Accrued interest payable and other liabilities | - | - | 2,079 |
| Issuance of common stock | - | - | 17,546 |

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PART IV

ITEM 15 - EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements. See Item 8 for reference.

(a)(2) Financial Statement Schedules. All applicable financial statement schedules required under Regulation S-X have been included in the Notes to the Consolidated Financial Statements.

(a)(3) Exhibits. The exhibits required by Item 601 of Regulation S-K are listed below.

EXHIBIT INDEX

| Exhibit # | | Location |
|-----------|---|--|
| 3.1 | Amended and Restated Articles of Incorporation Dated August 20, 1997 | Exhibit 4.1 on Form S-3 filed August 20, 1997 |
| 3.2 | <u>Amended Bylaws dated November 18, 2008</u> | Exhibit 3.2 on Form 8-K filed November 19, 2008 |
| 10.1 | Deferred Compensation Agreement between American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008 | Filed herewith |
| 10.2 | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008 | Filed herewith |
| 10.3 | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Jeffrey V. Haley dated December 31, 2008 | Filed herewith |
| 10.4 | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and R. Helm Dobbins dated December 31, 2008 | Filed herewith |
| 10.5 | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Dabney T. P. Gilliam, Jr. dated December 31, 2008 | Filed herewith |
| 10.6 | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and S. Cabell Dudley, Jr. dated December 31, 2008 | Filed herewith |

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| | | |
|------|---|--|
| 10.7 | <u>American National Bankshares Inc. 2008 Stock Incentive Plan</u> | Exhibit 99.0 to Form S-8 filed on May 30, 2008 |
| 11.1 | Refer to EPS calculation in the Notes to Financial Statements | Filed herewith |
| 21.1 | Subsidiaries of the registrant | Filed herewith |
| 31.1 | Section 302 Certification of Charles H. Majors, President and CEO | Filed herewith |
| 31.2 | Section 302 Certification of Charles H. Majors, President and Interim Principal Financial Officer | Filed herewith |
| 32.1 | Section 906 Certification of Charles H. Majors, President and CEO | Filed herewith |
| 32.2 | Section 906 Certification of Charles H. Majors, President and Interim Principal Financial Officer | Filed herewith |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 11, 2009

AMERICAN NATIONAL BANKSHARES INC.

By: /s/ Charles H. Majors
President and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 11, 2009.

/s/ Charles H. Majors President and Chief Executive Officer
Charles H. Majors and Interim Principal Financial Officer

/s/ Fred A. Blair Director
Fred A. Blair

/s/ Frank C. Crist, Jr. Director
Frank C. Crist, Jr.,
D.D.S.

/s/ Ben J. Davenport, Jr. Director
Ben J. Davenport, Jr.

/s/ H. Dan Davis Director
H. Dan Davis

/s/ Michael P. Haley Director
Michael P. Haley

/s/ Charles S. Harris Director
Charles S. Harris

/s/ Lester A. Hudson, Director
Jr.
Lester A. Hudson, Jr.,
Ph.D.

/s/ E. Budge Kent, Jr. Director
E. Budge Kent, Jr.

/s/ Fred B. Leggett, Jr. Director
Fred B. Leggett, Jr.

/s/ Franklin W. Maddux Director
Franklin W. Maddux,
M.D.

/s/ Martha W. Medley Director
Martha W. Medley

/s/ Claude B. Owen, Jr. Director
Claude B. Owen, Jr.

/s/ James R. Jefferson Assistant Treasurer and
James R. Jefferson Interim Principal Accounting Officer

