

AMERICAN NATIONAL BANKSHARES INC
Form 10-Q
August 08, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2008.

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number 0-12820

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

| | |
|---|---|
| VIRGINIA | 54-1284688 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|------------|
| 628 Main Street | 24541 |
| Danville, Virginia | (Zip Code) |
| (Address of principal executive offices) | |

(434) 792-5111
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

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 Exchange Act) Yes No

At August 7, 2008, the Company had 6,093,712 shares Common Stock outstanding, \$1 par value.

AMERICAN NATIONAL BANKSHARES INC.

| Index | | Page |
|-----------------|---|------|
| <u>Part I.</u> | <u>FINANCIAL INFORMATION</u> | |
| <u>Item 1</u> | <u>Financial Statements (Unaudited)</u> | |
| | <u>Consolidated Balance Sheets as of June 30, 2008</u> 3 <u>and December 31, 2007</u> | |
| | <u>Consolidated Statements of Income for the three</u> 4 <u>months ended June 30, 2008 and 2007</u> | |
| | <u>Consolidated Statements of Income for the six</u> 5 <u>months ended June 30, 2008 and 2007</u> | |
| | <u>Consolidated Statements of Changes in</u> 6 <u>Shareholders' Equity for the six months ended</u> <u>June 30, 2008 and 2007</u> | |
| | <u>Consolidated Statements of Cash Flows for the</u> 7 <u>six months ended June 30, 2008 and 2007</u> | |
| | <u>Notes to Consolidated Financial Statements</u> 8 | |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis of the</u> 18 <u>Financial Condition and Results of Operations</u> | |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures about</u> 31 <u>Market Risk</u> | |
| <u>Item 4.</u> | <u>Controls and Procedures</u> 32 | |
| <u>Part II.</u> | <u>OTHER INFORMATION</u> | |
| <u>Item 1.</u> | <u>Legal Proceedings</u> 33 | |
| <u>Item 1A.</u> | <u>Risk Factors</u> 33 | |
| <u>Item 2.</u> | <u>Unregistered Sales of Equity Securities and Use</u> 33 <u>of Proceeds</u> | |
| <u>Item 3</u> | <u>Defaults Upon Senior Securities</u> 33 | |
| <u>Item 4.</u> | <u>Submission of Matters to a Vote of Security</u> 33 <u> Holders</u> | |

| | | |
|---------------|--------------------------|----|
| <u>Item 5</u> | <u>Other Information</u> | 34 |
| <u>Item 6</u> | <u>Exhibits</u> | 34 |

SIGNATURES

American National Bankshares Inc. and Subsidiaries
Consolidated Balance Sheets
(Dollars in thousands, except share data)

| | (Unaudited) June 30, 2008 | (Audited) December 31, 2007 |
|---|---------------------------------|-----------------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 20,082 | \$ 18,155 |
| Interest-bearing deposits in other banks | 8,265 | 149 |
| Securities available for sale, at fair value | 136,632 | 145,159 |
| Securities held to maturity (fair value of \$10,033 in 2008 and \$12,250 in 2007) | 9,828 | 11,990 |
| Total securities | 146,460 | 157,149 |
| Loans held for sale (includes \$47 at fair value in 2008) | 2,200 | 1,368 |
| Loans, net of unearned income | 568,830 | 551,391 |
| Less allowance for loan losses | (7,932) | (7,395) |
| Net loans | 560,898 | 543,996 |
| Premises and equipment, net | 13,659 | 13,348 |
| Goodwill | 22,468 | 22,468 |
| Core deposit intangibles, net | 2,264 | 2,452 |
| Accrued interest receivable and other assets | 14,399 | 13,203 |
| Total assets | \$ 790,695 | \$ 772,288 |
| LIABILITIES and SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits -- noninterest bearing | \$ 98,005 | \$ 99,231 |
| Demand deposits -- interest bearing | 105,809 | 104,751 |
| Money market deposits | 52,772 | 50,254 |
| Savings deposits | 61,469 | 62,400 |
| Time deposits | 251,189 | 264,585 |
| Total deposits | 569,244 | 581,221 |
| Repurchase agreements | 57,973 | 47,891 |
| FHLB borrowings | 37,488 | 16,137 |
| Trust preferred capital notes | 20,619 | 20,619 |
| Accrued interest payable and other liabilities | 3,475 | 4,909 |
| Total liabilities | 688,799 | 670,777 |
| Shareholders' equity: | | |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | |
|--|------------|------------|
| Preferred stock, \$5 par, 200,000 shares authorized, none outstanding | - | - |
| Common stock, \$1 par, 10,000,000 shares authorized, 6,097,862 shares outstanding at June 30, 2008 and 6,118,717 shares outstanding at December 31, 2007 | 6,098 | 6,119 |
| Capital in excess of par value | 26,463 | 26,425 |
| Retained earnings | 70,233 | 69,409 |
| Accumulated other comprehensive income (loss), net | (898) | (442) |
| Total shareholders' equity | 101,896 | 101,511 |
| Total liabilities and shareholders' equity | \$ 790,695 | \$ 772,288 |

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Income
(Dollars in thousands, except per share and per share data) (Unaudited)

| | Three Months Ended June 30 | |
|---|-------------------------------|-----------|
| | 2008 | 2007 |
| Interest and Dividend Income: | | |
| Interest and fees on loans | \$ 8,987 | \$ 10,408 |
| Interest and dividends on securities: | | |
| Taxable | 1,234 | 1,028 |
| Tax-exempt | 420 | 420 |
| Dividends | 73 | 82 |
| Other interest income | 74 | 168 |
| Total interest and dividend income | 10,788 | 12,106 |
| Interest Expense: | | |
| Interest on deposits | 3,116 | 3,860 |
| Interest on repurchase agreements | 339 | 449 |
| Interest on other borrowings | 259 | 170 |
| Interest on trust preferred capital notes | 344 | 344 |
| Total interest expense | 4,058 | 4,823 |
| Net Interest Income | 6,730 | 7,283 |
| Provision for Loan Losses | 600 | - |
| Net Interest Income After Provision for Loan Losses | 6,130 | 7,283 |
| Noninterest Income: | | |
| Trust fees | 916 | 924 |
| Service charges on deposit accounts | 601 | 625 |
| Other fees and commissions | 226 | 198 |
| Mortgage banking income | 200 | 329 |
| Brokerage fees | 101 | 159 |
| Securities gains (losses), net | (138) | 64 |
| Impairment of securities | (255) | - |
| Other | 190 | 132 |
| Total noninterest income | 1,841 | 2,431 |
| Noninterest Expense: | | |
| Salaries | 2,481 | 2,514 |
| Employee benefits | 777 | 737 |
| Occupancy and equipment | 928 | 850 |
| Bank franchise tax | 173 | 165 |
| Core deposit intangible amortization | 95 | 95 |
| Other | 1,189 | 1,087 |
| Total noninterest expense | 5,643 | 5,448 |
| Income Before Income Taxes | 2,328 | 4,266 |
| Income Taxes | 519 | 1,235 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | |
|------------------------------------|-----------|-----------|
| Net Income | \$ 1,809 | \$ 3,031 |
| Net Income Per Common Share: | | |
| Basic | \$ 0.30 | \$ 0.49 |
| Diluted | \$ 0.30 | \$ 0.49 |
| Average Common Shares Outstanding: | | |
| Basic | 6,098,184 | 6,150,216 |
| Diluted | 6,108,536 | 6,177,165 |

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Income
(Dollars in thousands, except per share and per share data) (Unaudited)

| | Six Months Ended June 30 | |
|---|-----------------------------|-----------|
| | 2008 | 2007 |
| Interest and Dividend Income: | | |
| Interest and fees on loans | \$ 18,431 | \$ 20,487 |
| Interest and dividends on securities: | | |
| Taxable | 2,465 | 2,164 |
| Tax-exempt | 852 | 843 |
| Dividends | 150 | 171 |
| Other interest income | 150 | 339 |
| Total interest and dividend income | 22,048 | 24,004 |
| Interest Expense: | | |
| Interest on deposits | 6,698 | 7,643 |
| Interest on repurchase agreements | 790 | 875 |
| Interest on other borrowings | 418 | 687 |
| Interest on trust preferred capital notes | 687 | 376 |
| Total interest expense | 8,593 | 9,581 |
| Net Interest Income | 13,455 | 14,423 |
| Provision for Loan Losses | 740 | 303 |
| Net Interest Income After Provision for Loan Losses | 12,715 | 14,120 |
| Noninterest Income: | | |
| Trust fees | 1,796 | 1,803 |
| Service charges on deposit accounts | 1,166 | 1,247 |
| Other fees and commissions | 429 | 398 |
| Mortgage banking income | 395 | 519 |
| Brokerage fees | 244 | 248 |
| Securities gains (losses), net | (108) | 89 |
| Impairment of securities | (255) | - |
| Other | 309 | 339 |
| Total noninterest income | 3,976 | 4,643 |
| Noninterest Expense: | | |
| Salaries | 4,950 | 4,904 |
| Employee benefits | 1,524 | 1,385 |
| Occupancy and equipment | 1,894 | 1,679 |
| Bank franchise tax | 350 | 333 |
| Core deposit intangible amortization | 189 | 189 |
| Other | 2,185 | 2,128 |
| Total noninterest expense | 11,092 | 10,618 |
| Income Before Income Taxes | 5,599 | 8,145 |
| Income Taxes | 1,485 | 2,410 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | |
|------------------------------------|-----------|-----------|
| Net Income | \$ 4,114 | \$ 5,735 |
| Net Income Per Common Share: | | |
| Basic | \$ 0.67 | \$ 0.93 |
| Diluted | \$ 0.67 | \$ 0.93 |
| Average Common Shares Outstanding: | | |
| Basic | 6,103,008 | 6,153,496 |
| Diluted | 6,114,911 | 6,181,107 |

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
Six Months Ended June 30, 2008 and 2007
(Dollars in thousands) (Unaudited)

| | Common Stock | | Capital in | Retained | Accumulated | Total |
|--|--------------|----------|------------------------|-----------|--|-------------------------|
| | Shares | Amount | Excess of Par Value | Earnings | Other Comprehensive Income (Loss) | Shareholders' Equity |
| Balance, December 31, 2006 | 6,161,865 | \$ 6,162 | \$ 26,414 | \$ 64,584 | \$ (2,168) | \$ 94,992 |
| Net income | - | - | - | 5,735 | - | 5,735 |
| Change in unrealized gains on securities available for sale, net of tax of \$(177) | - | - | - | - | (214) | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$(30) | - | - | - | - | (59) | |
| Other comprehensive income (loss) | | | | | (273) | (273) |
| Total comprehensive income | - | - | - | - | - | 5,462 |
| Stock repurchased and retired | (24,300) | (24) | (104) | (428) | - | (556) |
| Stock options exercised | 8,052 | 8 | 112 | - | - | 120 |
| Cash dividends declared (\$.45 per share) | - | - | - | (2,769) | - | (2,769) |
| Balance, June 30, 2007 | 6,145,617 | \$ 6,146 | \$ 26,422 | \$ 67,122 | \$ (2,441) | \$ 97,249 |
| | 6,118,717 | \$ 6,119 | \$ 26,425 | \$ 69,409 | \$ (442) | \$ 101,511 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

Balance, December
31, 2007

| | | | | | | |
|--|-----------|----------|-----------|-----------|----------|------------|
| Net income | - | - | - | 4,114 | - | 4,114 |
| Change in unrealized gains on securities available for sale, net of tax of \$(332) | - | - | - | - | (618) | |
| Add: Reclassification adjustment for losses on impairment of securities, net of tax of \$89 | - | - | - | - | 166 | |
| Less: Reclassification adjustment for losses on securities available for sale, net of tax of \$38 | - | - | - | - | 70 | |
| Change in pension liability, net of tax of \$(40) | | | | | (74) | |
| Other comprehensive income (loss) | | | | | (456) | (456) |
| Total comprehensive income | | | | | | 3,658 |
| Stock repurchased and retired | (31,200) | (31) | (135) | (484) | - | (650) |
| Stock options exercised | 10,345 | 10 | 173 | - | - | 183 |
| Cash dividends declared (\$.46 per share) | - | - | - | (2,806) | - | (2,806) |
| Balance, June 30, 2008 | 6,097,862 | \$ 6,098 | \$ 26,463 | \$ 70,233 | \$ (898) | \$ 101,896 |

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Six Months Ended June 30, 2008 and 2007
(Dollars in thousands) (Unaudited)

| | 2008 | 2007 |
|---|----------|----------|
| Cash Flows from Operating Activities: | | |
| Net income | \$ 4,114 | \$ 5,735 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 740 | 303 |
| Depreciation | 692 | 564 |
| Core deposit intangible amortization | 188 | 188 |
| Net amortization (accretion) of bond premiums and discounts | (121) | (59) |
| Net loss (gain) on sale or call of securities | 108 | (89) |
| Impairment of securities | 255 | - |
| Gain on loans held for sale | (337) | (397) |
| Proceeds from sales of loans held for sale | 16,400 | 17,862 |
| Originations of loans held for sale | (16,895) | (18,109) |
| Net loss (gain) on foreclosed real estate | 7 | (6) |
| Change in valuation allowance for foreclosed real estate | - | (10) |
| Gain on sale of premises and equipment | - | (9) |
| Deferred income tax expense | 19 | 92 |
| Net change in interest receivable | 66 | (15) |
| Net change in other assets | (1,224) | 1,117 |
| Net change in interest payable | (258) | (100) |
| Net change in other liabilities | (1,176) | (1,128) |
| Net cash provided by operating activities | 2,578 | 5,939 |
| Cash Flows from Investing Activities: | | |
| Proceeds from sales of securities available for sale | 814 | 665 |
| Proceeds from maturities and calls of securities available for sale | 28,991 | 31,589 |
| Proceeds from maturities and calls of securities held to maturity | 2,164 | 725 |
| Purchases of securities available for sale | (22,109) | (4,861) |
| Net change in loans | (17,694) | (9,590) |
| Purchases of bank property and equipment | (1,003) | (1,016) |
| Proceeds from sales of foreclosed real estate | 119 | 30 |
| Net cash (used in) provided by investing activities | (8,718) | 17,542 |
| Cash Flows from Financing Activities: | | |
| Net change in demand, money market, and savings deposits | 1,419 | 865 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | |
|---|-----------|-----------|
| Net change in time deposits | (13,396) | (13,649) |
| Net change in repurchase agreements | 10,082 | 10,247 |
| Net change in FHLB borrowings | 21,351 | (5,075) |
| Cash dividends paid | (2,806) | (2,769) |
| Repurchase of stock | (650) | (556) |
| Proceeds from exercise of stock options | 183 | 120 |
| Net cash provided by (used in) financing activities | 16,183 | (10,817) |
| Net Increase in Cash and Cash Equivalents | 10,043 | 12,664 |
| Cash and Cash Equivalents at Beginning of Period | 18,304 | 26,124 |
| Cash and Cash Equivalents at End of Period | \$ 28,347 | \$ 38,788 |

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

AMERICAN NATIONAL BANKSHARES INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Basis of Presentation

The unaudited 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.

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. 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 the Trust. Instead, the Corporation reflected this equity investment in the “Trust Preferred Capital Notes” line item in the consolidated balance sheets.

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

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information. Accordingly, the unaudited consolidated financial statements do not include all the information and footnotes required by GAAP for complete financial statements. The unaudited consolidated financial statements of the Company include, in the opinion of management, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of such financial statements for all periods presented. The financial position and results of operations as of and for the six months ended June 30, 2008, are not necessarily indicative of the results of operations that may be expected in the future. Please refer to the Company’s 2007 Annual Report on Form 10-K for additional information related to the Company’s audited consolidated financial statements for the three years ended December 31, 2007, including the related notes to consolidated financial statements.

The preparation of the financial statements in accordance with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates and assumptions. The Company regularly assesses various assets for impairment as dictated by applicable GAAP, giving appropriate consideration to general economic and specific market factors. The accounting policies that are particularly sensitive to judgments and the extent to which significant estimates are used include allowance for loan losses and the reserve for unfunded lending commitments, fair value of certain financial instruments, consolidation, goodwill impairment, and contingent liabilities.

Certain reclassifications have been made to prior period balances to conform to the current period presentation.

Note 2 – New Accounting Pronouncements

In March 2008, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 161, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133. SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

Adoption of New Accounting Standards:

In the first quarter of 2008, the Company adopted SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (the “fair value option”) and requires an entity to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. SFAS 159 was effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 did not have a material effect on the Company’s financial position or results of operations.

In the first quarter of 2008, the Company adopted SFAS 157, Fair Value Measurements. 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 may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. Further discussion on this standard can be found in Note 11 to the unaudited consolidated financial statements.

Refer to the Company’s December 31, 2007 Annual Report on Form 10-K for previously announced accounting pronouncements.

Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at June 30, 2008 and December 31, 2007 were as follows:

| (in thousands) | Amortized Cost | June 30, 2008 | | Estimated Fair Value |
|-------------------------------------|-------------------|---------------------|----------------------|-------------------------|
| | | Unrealized Gains | Unrealized Losses | |
| Securities available for sale: | | | | |
| Debt securities: | | | | |
| Federal agencies | \$ 43,625 | \$ 1,062 | \$ 48 | \$ 44,639 |
| Mortgage-backed | 48,614 | 490 | 421 | 48,683 |
| State and municipal | 36,849 | 199 | 180 | 36,868 |
| Corporate | 1,485 | - | 48 | 1,437 |
| Equity securities: | | | | |
| FHLB stock – restricted | 3,076 | - | - | 3,076 |
| Federal Reserve stock – restricted | 1,429 | - | - | 1,429 |
| FNMA and FHLMC preferred stock | 392 | - | - | 392 |
| Other | 108 | - | - | 108 |
| Total securities available for sale | 135,578 | 1,751 | 697 | 136,632 |
| Debt securities held to maturity: | | | | |
| Mortgage-backed | 279 | 10 | - | 289 |
| State and municipal | 9,549 | 203 | 8 | 9,744 |
| Total securities held to maturity | 9,828 | 213 | 8 | 10,033 |
| Total securities | \$ 145,406 | \$ 1,964 | \$ 705 | \$ 146,665 |

| (in thousands) | December 31, 2007 | | | |
|-------------------------------------|-------------------|---------------------|----------------------|-------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| 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 |
| 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 |
| Debt 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 |

The tables below show 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 June 30, 2008 and December 31, 2007. 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.

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. As of June 30, 2008, the Company held five securities that had been in a continuous unrealized loss position for twelve months or more. The Company has reviewed these securities, in accordance with its accounting policy, for other-than-temporary impairment, and does not consider the balances presented in the table to be other-than-temporarily impaired as of June 30, 2008.

An other-than-temporary impairment expense of \$255,000 on FHLMC preferred stock was charged to earnings during the quarter ended June 30, 2008. The market value of the securities dropped significantly, and any near-term recovery in value was considered uncertain as of June 30, 2008. The Company's recorded investment in these securities, after the impairment charge, was \$392,000 at June 30, 2008.

June 30, 2008

| (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 agency | \$ 5,529 | \$ 48 | \$ 5,529 | \$ 48 | \$ - | \$ - |
| Mortgage-backed | 15,212 | 421 | 14,092 | 415 | 1,120 | 6 |
| State and municipal | 13,056 | 188 | 13,056 | 188 | - | - |
| Corporate | 1,437 | 48 | - | - | 1,437 | 48 |
| Total | \$ 35,234 | \$ 705 | \$ 32,677 | \$ 651 | \$ 2,557 | \$ 54 |

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) | June 30, 2008 | December 31, 2007 |
|-----------------------------------|-------------------|-------------------|
| Construction and land development | \$ 66,740 | \$ 69,803 |
| Commercial real estate | 201,102 | 198,332 |
| Residential real estate | 140,024 | 133,899 |
| Home equity | 52,773 | 48,313 |
| Total real estate | 460,639 | 450,347 |
| Commercial and industrial | 99,603 | 91,028 |
| Consumer | 8,588 | 10,016 |
| Total loans | \$ 568,830 | \$ 551,391 |

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

| (in thousands) | June 30, 2008 | December 31, 2007 |
|--|---------------|-------------------|
| Impaired loans with a valuation allowance | \$ 6,541 | \$ 3,092 |
| Impaired loans without a valuation allowance | 523 | 473 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | | | |
|---|----|-------|----|-------|
| Total impaired loans | \$ | 7,064 | \$ | 3,565 |
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ | 2,354 | \$ | 1,499 |
| Nonaccrual loans excluded from the impaired loan disclosure | \$ | 1,406 | \$ | 1,329 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| (in thousands) | As of and For the Three Months Ended June 30, 2008 | As of and For the Six Months Ended June 30, 2008 | As of and For the Three Months Ended June 30, 2007 | As of and For the Six Months Ended June 30, 2007 |
|--|--|--|--|--|
| Average balance in impaired loans | \$ 5,729 | \$ 4,687 | \$ 2,292 | \$ 1,939 |
| Interest income recognized on impaired loans | 59 | 108 | 103 | 107 |
| Interest income recognized on nonaccrual loans | - | - | - | - |
| Interest on non-accrual loans had they been accruing | 96 | 169 | 73 | 148 |
| Loans past due 90 days and still accruing interest | 172 | 172 | - | - |

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

Foreclosed real estate was \$558,000 at June 30, 2008 and \$632,000 at December 31, 2007, and is included in other assets on the Consolidated Balance Sheets.

Note 5 – 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 the six months ended June 30, 2008 and 2007, and for the year ended December 31, 2007, are presented below:

| (in thousands) | Six Months Ended June 30, 2008 | Year Ended December 31, 2007 | Six Months Ended June 30, 2007 |
|---|---|---------------------------------------|---|
| Allowance for Loan Losses | | | |
| Balance, beginning of period | \$ 7,395 | \$ 7,264 | \$ 7,264 |
| Provision for loan losses | 740 | 403 | 303 |
| Charge-offs | (373) | (515) | (204) |
| Recoveries | 170 | 243 | 130 |
| Balance, end of period | \$ 7,932 | \$ 7,395 | \$ 7,493 |
| Reserve for Unfunded Lending Commitments | | | |
| Balance, beginning of period | \$ 151 | 123 | 123 |
| Provision for unfunded commitments | 218 | 28 | 5 |
| Balance, end of period | \$ 369 | 151 | 128 |

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

Note 6 – 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 2007 that determined the market value of the Company's shares exceeded 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 three months ended June 30, 2008, are as follows (in thousands):

| | |
|-------------------------------------|-----------|
| Balance as of December 31, 2007 | \$ 22,468 |
| Goodwill recorded during the period | - |
| Impairment losses | - |
| Balance as of June 30, 2008 | \$ 22,468 |

Core deposit intangible assets resulting from an acquisition were originally recorded at \$3,112,000 in April 2006, and are being amortized over 99 months on a straight-line basis.

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

| | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
|---|----------------------------|-----------------------------|--------------------------|
| June 30, 2008 | | | |
| Amortizable core deposit intangibles | \$ 7,616 | \$ 5,352 | \$ 2,264 |
| Goodwill | 22,468 | - | \$ 22,468 |
| December 31, 2007 | | | |
| Amortizable core deposit intangibles | \$ 7,616 | \$ 5,164 | \$ 2,452 |
| Goodwill | 22,468 | - | \$ 22,468 |
| June 30, 2007 | | | |
| Amortizable core deposit intangibles | \$ 7,616 | \$ 4,975 | \$ 2,641 |
| Goodwill | 22,468 | - | \$ 22,468 |

Note 7 – Stock Based Compensation

A summary of stock option transactions for the three months ended June 30, 2008, is as follows:

| Option Shares | Weighted Average | Weighted Average Remaining Contractual Term | Average Intrinsic Value |
|------------------|---------------------|---|-------------------------------|
|------------------|---------------------|---|-------------------------------|

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | Exercise Price | | (\$000) |
|-------------------------------------|----------|-------------------|-----|---------|
| Outstanding at December 31, 2007 | 174,871 | \$ 21.15 | 4.3 | \$ 263 |
| Granted | - | - | | |
| Exercised | (10,345) | 17.65 | | |
| Forfeited | (2,200) | 14.54 | | |
| Outstanding at June 30, 2008 | 162,326 | 21.40 | 4.1 | 157 |
| Exercisable at June 30, 2008 | 162,326 | 21.40 | 4.1 | 157 |

The total estimated intrinsic value of options exercised during the six month period ended June 30, 2008 was \$44,000.

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 were fully vested prior to January 1, 2006; therefore, adoption of SFAS 123R resulted in no compensation expense. No options have been granted since the January 1, 2006 adoption date. There was no tax benefit associated with stock option activity during 2007, 2006, or 2005. 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.

Note 8 – 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.

| | Three Months Ended June 30, | | | |
|--|--------------------------------|------------------------|-----------|------------------------|
| | 2008 | | 2007 | |
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic | 6,098,184 | \$.30 | 6,150,216 | \$.49 |
| Effect of dilutive securities - stock options | 10,352 | - | 26,949 | - |
| Diluted | 6,108,536 | \$.30 | 6,177,165 | \$.49 |

| | Six Months Ended June 30, | | | |
|--|------------------------------|------------------------|-----------|------------------------|
| | 2008 | | 2007 | |
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic | 6,103,008 | \$.67 | 6,153,496 | \$.93 |
| Effect of dilutive securities - stock options | 11,903 | - | 27,611 | - |
| Diluted | 6,114,911 | \$.67 | 6,181,107 | \$.93 |

Stock options on common stock which were not included in computing diluted earnings per share for the six month periods ended June 30, 2008 and 2007, because their effects were antidilutive, averaged 116,511 and 88,027 shares, respectively.

Note 9 – Employee Benefit Plans

Effective April 1, 2008 the Company adopted the measurement date provisions of SFAS 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans.” Under SFAS 158, the measurement date is required to be the Company’s fiscal year-end. The Company’s pension plan previously used an October 31 measurement date. The plan is now measured as of December 31, consistent with the Company’s fiscal year-end. The non-cash effect of the adoption of SFAS 158 resulted in a decrease to shareholders' equity of approximately \$74,000 and an increase in other assets of \$114,000. There was no effect on the Company’s results of operations.

Following is information pertaining to the Company's non-contributory defined benefit pension plan.

| Components of Net Periodic Benefit Cost (in thousands) | Three Months Ended | | Six Months Ended | |
|--|--------------------|---------------|------------------|---------------|
| | June 30, | | June 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ 181 | \$ 164 | \$ 362 | \$ 328 |
| Interest cost | 129 | 105 | 257 | 210 |
| Expected return on plan assets | (164) | (141) | (328) | (282) |
| Amortization of prior service cost | (1) | (1) | (1) | (1) |
| Recognized net actuarial loss | 28 | 38 | 56 | 76 |
| Net periodic benefit cost | \$ 173 | \$ 165 | \$ 346 | \$ 331 |

The Company's maximum estimated contribution for 2008 is \$7,100,000. Cash contributions to the plan for the six months ended June 30, 2008 were \$2,000,000.

Note 10 – 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 automatic 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. Fees are also received by this division for individual retirement accounts managed for the community banking segment.

Amounts shown in the "Other" column include activities of American National Bankshares Inc. and its subsidiary, AMNB Statutory Trust I. Refer to Note 1 for additional information on AMNB Statutory Trust I. 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 three and six month periods ended June 30, 2008 and 2007, is shown in the following table.

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| (in thousands) | Three Months Ended June 30, 2008 | | | | |
|--------------------------------------|----------------------------------|-------------------------------|-------|---------------------------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 10,788 | \$ - | \$ - | \$ - | \$ 10,788 |
| Interest expense | 3,714 | - | 344 | - | 4,058 |
| Noninterest income | 815 | 1,017 | 9 | - | 1,841 |
| Operating income before income taxes | 2,207 | 520 | (399) | - | 2,328 |
| Depreciation and amortization | 427 | 6 | - | - | 433 |
| Total assets | 789,926 | - | 769 | - | 790,695 |
| Capital expenditures | 600 | 6 | - | - | 606 |

| | Three Months Ended June 30, 2007 | | | | |
|--------------------------------------|----------------------------------|-------------------------------|-------|---------------------------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 12,106 | \$ - | \$ - | \$ - | \$ 12,106 |
| Interest expense | 4,479 | - | 344 | - | 4,823 |
| Noninterest income | 1,332 | 1,083 | 16 | - | 2,431 |
| Operating income before income taxes | 3,989 | 673 | (396) | - | 4,266 |
| Depreciation and amortization | 370 | 6 | - | - | 376 |
| Total assets | 770,357 | - | 780 | - | 771,137 |
| Capital expenditures | 408 | 14 | - | - | 422 |

| | Six Months Ended June 30, 2008 | | | | |
|--------------------------------------|--------------------------------|-------------------------------|-------|---------------------------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 22,048 | \$ - | \$ - | \$ - | \$ 22,048 |
| Interest expense | 7,906 | - | 687 | - | 8,593 |
| Noninterest income | 1,911 | 2,040 | 25 | - | 3,976 |
| Operating income before income taxes | 5,318 | 1,086 | (805) | - | 5,599 |
| Depreciation and amortization | 867 | 12 | 1 | - | 880 |
| Total assets | 789,926 | - | 769 | - | 790,695 |
| Capital expenditures | 997 | 6 | - | - | 1,003 |

| | Six Months Ended June 30, 2007 | | | | |
|--------------------------------------|--------------------------------|-------------------------------|-------|---------------------------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 24,004 | \$ - | \$ - | \$ - | \$ 24,004 |
| Interest expense | 8,894 | - | 687 | - | 9,581 |
| Noninterest income | 2,537 | 2,051 | 55 | - | 4,643 |
| Operating income before income taxes | 7,751 | 1,171 | (777) | - | 8,145 |
| Depreciation and amortization | 740 | 11 | 1 | - | 752 |
| Total assets | 770,357 | - | 780 | - | 771,137 |
| Capital expenditures | 1,000 | 16 | - | - | 1,016 |

Note 11 – Supplemental Cash Flow Information

| (in thousands) | Six Months Ended | |
|--|------------------|-----------|
| | June 30, 2008 | 2007 |
| Supplemental Schedule of Cash and Cash Equivalents: | | |
| Cash and due from banks | \$ 20,082 | \$ 21,735 |
| Interest-bearing deposits in other banks | 8,265 | 17,053 |
| | \$ 28,347 | \$ 38,788 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid for: | | |
| Interest on deposits and borrowed funds | \$ 8,850 | \$ 9,681 |
| Income taxes | 1,972 | 1,022 |
| Noncash investing and financing activities: | | |
| Transfer of loans to other real estate owned | 52 | - |
| Unrealized gain (loss) on securities available for sale | (587) | (420) |

Note 12 – Fair Value Measurements

During the first quarter of 2008, the Company adopted SFAS 157, Fair Value Measurements. Under SFAS 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The three levels are defined as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
 - Level 3 inputs are unobservable inputs for the asset or liability.

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds such as U.S. Treasury securities. The fair value for Level 2 securities is estimated by using pricing models, quoted prices of similar securities with similar characteristics, discounted cash flow, or other valuation methodologies. The pricing models are primarily industry-standard models that consider various assumptions, including time value, yield curve, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. These assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace. Level 2 securities would include U.S. agency securities, mortgage-backed agency and non-agency securities, obligations of states and political subdivisions, and certain corporate, asset backed, and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the

valuation hierarchy. All of the Company's securities are considered to be Level 2 securities as of June 30, 2008.

Loans Held for Sale and Mortgage Loan Derivative Contracts

Loans held for sale and mortgage loan derivative contracts are measured at fair value based upon published rates from one of the Company's mortgage loan investors.

At June 30, 2008, the Company's assets and liabilities at fair value are allocated between Levels 1, 2 and 3 (in thousands) as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|-------------------------------------|---------|---------|---------|---------|
| Securities available for sale | - \$ | 136,632 | - \$ | 136,632 |
| Securities held to maturity | - | 9,828 | - | 9,828 |
| Loans held for sale | - | 2,200 | - | 2,200 |
| Mortgage loan derivative contracts: | | | | |
| Gross positive fair value | - | 15 | - | 15 |
| Gross negative fair value | - | (27) | - | (27) |

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on important factors affecting the financial condition and results of operations of the Company. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements.

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 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.

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 in the Company's 2007 Annual Report on Form 10-K.

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 Loan 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 No. ("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.

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 2007 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.

Internet Access to Corporate Documents

The Company provides access to its SEC filings through a link on the Investors Relations page of the Company's web site 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.

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. The Bank also manages \$471 million of assets in its Trust and Investment Services Division.

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-three 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 and other funding sources. 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.

Net interest income during the second quarter was \$6.73 million, approximately the same as recorded during the first quarter of 2008, and down 7.6% from the second quarter of 2007. Net interest income was adversely impacted by a series of rate reductions enacted by the Federal Reserve from September 2007 to April 2008. The net interest margin was 3.83% during the recently completed quarter, down from 3.88% in the previous quarter and 4.26% in the second quarter of 2007. Net interest income was augmented in the current quarter by \$84,000 related to the payoff of a loan acquired in a merger and accounted for under special accounting rules for acquired loans. Loans increased \$10.8 million, on average, over the previous quarter, while average deposits and customer repurchase accounts declined \$8.3 million. Largely as a result of these changes, the company increased its average borrowings by \$18.1 million during the quarter.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the first quarter 2008 and 2007. 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.

Net Interest Income Analysis
For the Three Months Ended June 30, 2008 and 2007
(in thousands, except rates)

| | Average Balance | | Interest Income/Expense | | Yield/Rate | |
|--|-----------------|------------|----------------------------|----------|------------|-------|
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Loans: | | | | | | |
| Commercial | \$ 90,648 | \$ 91,852 | \$ 1,342 | \$ 1,819 | 5.92% | 7.92% |
| Real estate | 467,424 | 448,024 | 7,468 | 8,364 | 6.39 | 7.47 |
| Consumer | 8,903 | 10,434 | 197 | 247 | 8.85 | 9.47 |
| Total loans | 566,975 | 550,310 | 9,007 | 10,430 | 6.35 | 7.58 |
| Securities: | | | | | | |
| Federal agencies | 45,708 | 68,991 | 551 | 748 | 4.82 | 4.34 |
| Mortgage-backed & CMO's | 50,357 | 20,501 | 642 | 247 | 5.10 | 4.82 |
| State and municipal | 47,201 | 45,623 | 652 | 628 | 5.53 | 5.51 |
| Other | 6,981 | 7,991 | 90 | 116 | 5.16 | 5.81 |
| Total securities | 150,247 | 143,106 | 1,935 | 1,739 | 5.15 | 4.86 |
| Deposits in other banks | 8,567 | 12,869 | 74 | 168 | 3.46 | 5.22 |
| Total interest-earning assets | 725,789 | 706,285 | 11,016 | 12,337 | 6.07 | 6.99 |
| Non-earning assets | 63,623 | 64,425 | | | | |
| Total assets | \$ 789,412 | \$ 770,710 | | | | |
| Deposits: | | | | | | |
| Demand | \$ 107,154 | \$ 111,064 | 160 | 416 | 0.60 | 1.50 |
| Money market | 51,124 | 52,279 | 239 | 356 | 1.87 | 2.72 |
| Savings | 62,648 | 67,716 | 84 | 230 | 0.54 | 1.36 |
| Time | 255,281 | 256,263 | 2,633 | 2,858 | 4.13 | 4.46 |
| Total deposits | 476,207 | 487,322 | 3,116 | 3,860 | 2.62 | 3.17 |
| Repurchase agreements | 53,535 | 46,032 | 339 | 449 | 2.53 | 3.90 |
| Other borrowings | 52,012 | 33,884 | 603 | 514 | 4.64 | 6.07 |
| Total interest-bearing liabilities | 581,754 | 567,238 | 4,058 | 4,823 | 2.79 | 3.40 |
| Noninterest bearing demand deposits | 99,960 | 101,024 | | | | |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

| | | | | |
|---|---------|------------|----------|-------|
| Other liabilities | 5,187 | 5,265 | | |
| Shareholders' equity | 102,511 | 97,183 | | |
| Total liabilities and shareholders' equity \$ | 789,412 | \$ 770,710 | | |
| Interest rate spread | | | 3.28% | 3.59% |
| Net interest margin | | | 3.83% | 4.26% |
| Net interest income (taxable equivalent basis) | | 6,958 | 7,514 | |
| Less: Taxable equivalent adjustment | | 228 | 231 | |
| Net interest income | | \$ 6,730 | \$ 7,283 | |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

Net Interest Income Analysis
For the Six Months Ended June 30, 2008 and 2007
(in thousands, except rates)

| | Average Balance | | Interest Income/Expense | | Yield/Rate | |
|--|-----------------|------------|----------------------------|----------|------------|-------|
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Loans: | | | | | | |
| Commercial | \$ 88,140 | \$ 90,415 | \$ 2,796 | \$ 3,512 | 6.34% | 7.77% |
| Real estate | 463,927 | 446,448 | 15,257 | 16,529 | 6.58 | 7.40 |
| Consumer | 9,213 | 10,390 | 414 | 489 | 8.99 | 9.41 |
| Total loans | 561,280 | 547,253 | 18,467 | 20,530 | 6.58 | 7.50 |
| Securities: | | | | | | |
| Federal agencies | 47,886 | 75,587 | 1,148 | 1,605 | 4.79 | 4.25 |
| Mortgage-backed & CMO's | 48,881 | 20,253 | 1,245 | 488 | 5.09 | 4.82 |
| State and municipal | 47,524 | 45,792 | 1,308 | 1,262 | 5.50 | 5.51 |
| Other | 6,682 | 8,372 | 189 | 245 | 5.66 | 5.85 |
| Total securities | 150,973 | 150,004 | 3,890 | 3,600 | 5.15 | 4.80 |
| Deposits in other banks | 9,488 | 13,064 | 150 | 339 | 3.16 | 5.19 |
| Total interest-earning assets | 721,741 | 710,321 | 22,507 | 24,469 | 6.24 | 6.89 |
| Non-earning assets | 63,031 | 64,346 | | | | |
| Total assets | \$ 784,772 | \$ 774,667 | | | | |
| Deposits: | | | | | | |
| Demand | \$ 107,574 | \$ 110,592 | 385 | 840 | 0.72 | 1.52 |
| Money market | 51,222 | 52,210 | 533 | 705 | 2.08 | 2.70 |
| Savings | 62,916 | 68,318 | 200 | 465 | 0.64 | 1.36 |
| Time | 259,491 | 259,426 | 5,580 | 5,633 | 4.30 | 4.34 |
| Total deposits | 481,203 | 490,546 | 6,698 | 7,643 | 2.78 | 3.12 |
| Repurchase agreements | 54,079 | 46,142 | 790 | 875 | 2.92 | 3.79 |
| Other borrowings | 42,941 | 35,294 | 1,105 | 1,063 | 5.15 | 6.02 |
| Total interest-bearing liabilities | 578,223 | 571,982 | 8,593 | 9,581 | 2.97 | 3.35 |
| Noninterest bearing | | | | | | |
| demand deposits | 98,586 | 101,177 | | | | |
| Other liabilities | 5,553 | 5,074 | | | | |
| Shareholders' equity | 102,410 | 96,434 | | | | |

| | | | | |
|--|------------|------------|-------|--------|
| Total liabilities and shareholders' equity | \$ 784,772 | \$ 774,667 | | |
| Interest rate spread | | | 3.27% | 3.54% |
| Net interest margin | | | 3.86% | 4.19% |
| Net interest income (taxable equivalent basis) | | 13,914 | | 14,888 |
| Less: Taxable equivalent adjustment | | 459 | | 465 |
| Net interest income | \$ | 13,455 | \$ | 14,423 |

Changes in Net Interest Income (Rate/Volume Analysis)
(in thousands)

| Interest income | Interest Increase (Decrease) | Three Months Ended June 30 2008 vs. 2007 | |
|-------------------------|------------------------------------|---|-------------------------------------|
| | | Rate | Change Attributable to Volume |
| Loans: | | | |
| Commercial | \$ (477) | \$ (453) | \$ (24) |
| Real Estate | (896) | (1,246) | 350 |
| Consumer | (50) | (15) | (35) |
| Total loans | (1,423) | (1,714) | 291 |
| Securities: | | | |
| Federal agencies | (197) | 77 | (274) |
| Mortgage-backed | 395 | 15 | 380 |
| State and municipal | 24 | 2 | 22 |
| Other securities | (26) | (12) | (14) |
| Total securities | 196 | 82 | 114 |
| Deposits in other banks | (94) | (47) | (47) |
| Total interest income | (1,321) | (1,679) | 358 |
| Interest expense | | | |
| Deposits: | | | |
| Demand | (256) | (242) | (14) |
| Money market | (117) | (109) | (8) |
| Savings | (146) | (130) | (16) |
| Time | (225) | (214) | (11) |
| Total deposits | (744) | (695) | (49) |
| Repurchase agreements | (110) | (175) | 65 |
| Other borrowings | 89 | (141) | 230 |
| Total interest expense | (765) | (1,011) | 246 |
| Net interest income | \$ (556) | \$ (668) | \$ 112 |

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

Changes in Net Interest Income (Rate/Volume Analysis)
(in thousands)

| Interest income | Interest Increase (Decrease) | Six Months Ended June 30 2008 vs. 2007 | |
|-------------------------|------------------------------------|---|-------------------------------------|
| | | Rate | Change Attributable to Volume |
| Loans: | | | |
| Commercial | \$ (716) | \$ (630) | \$ (86) |
| Real Estate | (1,272) | (1,900) | 628 |
| Consumer | (75) | (21) | (54) |
| Total loans | (2,063) | (2,551) | 488 |
| Securities: | | | |
| Federal agencies | (457) | 187 | (644) |
| Mortgage-backed | 757 | 29 | 728 |
| State and municipal | 46 | (2) | 48 |
| Other securities | (56) | (8) | (48) |
| Total securities | 290 | 206 | 84 |
| Deposits in other banks | (189) | (111) | (78) |
| Total interest income | (1,962) | (2,456) | 494 |
| Interest expense | | | |
| Deposits: | | | |
| Demand | (455) | (433) | (22) |
| Money market | (172) | (159) | (13) |
| Savings | (265) | (231) | (34) |
| Time | (53) | (54) | 1 |
| Total deposits | (945) | (877) | (68) |
| Repurchase agreements | (85) | (221) | 136 |
| Other borrowings | 42 | (168) | 210 |
| Total interest expense | (988) | (1,266) | 278 |
| Net interest income | \$ (974) | \$ (1,190) | \$ 216 |

Noninterest Income

Noninterest income totaled \$1.84 million in the second quarter of 2008, a decline of \$590,000 over the second quarter of 2007. Noninterest income was significantly impacted by expenses associated with the Company's preferred stock investments. During the quarter, the Company recorded a \$139,000 loss on sale of its remaining preferred stock investment in FNMA, and recorded an impairment loss of \$255,000 on its investment in FHLMC preferred stock. The impairment expense is classified as a reduction of other noninterest income. Excluding these items, noninterest income declined \$196,000 over the second quarter of 2007, due in large part to a reduction in mortgage banking and retail brokerage revenue.

Fees from the management of trusts, estates, and asset management accounts totaled \$916,000 in the second quarter of 2008 as compared to \$924,000 for the same period in 2007. Volatility in the financial markets negatively impacted account asset values, which offset the income from new account activity. A substantial portion of Trust fees are earned based on account values.

Service charges on deposit accounts were \$601,000, a decline of \$24,000 or 3.8% from the second quarter of 2007, primarily due to a drop in customer overdraft activity.

Mortgage banking income decreased 129,000 or 39.2% over the second quarter of 2007 due to a decline in consumer home purchase and refinance activity.

Brokerage fees decreased 36.5% to \$101,000 in the second quarter of 2008, from \$159,000 in the second quarter of 2007, due to decreased retail customer investment activity, which was unusually high in the second quarter 2007.

Other noninterest income increased \$58,000 in the second quarter of 2008 from the comparable quarter of 2007, due primarily to an increase in the estimated value of loans held for sale.

For the first six months of 2008, noninterest income was \$3.98 million, down 14.4% over the same period of 2007. Excluding the effect of the aforementioned special charges related to the Company's preferred stock investments in FNMA and FHLMC, noninterest income declined 5.9%. This decline was largely related to a reduction in customer overdraft activity, which reduced deposit service charges, and a reduction in mortgage loan activity, which reduced mortgage banking income.

| (in thousands) | Noninterest Income | | | |
|---|--------------------|----------|------------------|----------|
| | Three Months Ended | | Six Months Ended | |
| | 2008 | 2007 | 2008 | 2007 |
| Trust fees | \$ 916 | \$ 924 | \$ 1,796 | \$ 1,803 |
| Service charges on deposit accounts | 601 | 625 | 1,166 | 1,247 |
| Other fees and commissions | 226 | 198 | 429 | 398 |
| Mortgage banking income | 200 | 329 | 395 | 519 |
| Brokerage fees | 101 | 159 | 244 | 248 |
| Securities gains (losses), net | (138) | 64 | (108) | 89 |
| Impairment of securities | (255) | - | (255) | - |
| Investment in insurance companies | 65 | 40 | 71 | 131 |
| Bank owned life insurance | 34 | 33 | 67 | 66 |
| Check order charges | 33 | 33 | 62 | 65 |
| Increase in estimated fair value of loans held for sale | 47 | - | 47 | - |
| Gain from sale of bankcard processor | - | - | 39 | - |
| Other | 11 | 26 | 23 | 77 |
| | \$ 1,841 | \$ 2,431 | \$ 3,976 | \$ 4,643 |

Noninterest Expense

Noninterest expense totaled \$5.64 million in the second quarter of 2008, up 3.6% over the same quarter of 2007. Excluding \$176,000 of expense to increase the reserve for unfunded lending commitments, noninterest expense was approximately the same as the year-earlier quarter.

Salaries expense decreased \$33,000 or 1.3% in the second quarter of 2008 as compared to the same period in 2007, due primarily to reductions in profit sharing and incentive compensation accruals. Employee benefits expense increased \$40,000 or 5.4% over the same period last year primarily due to increases in employee insurance expenses.

Occupancy and equipment expense increased \$78,000 in the second quarter of 2008 as compared to the same period in 2007. This increase was due primarily to investments in new operational technology and costs associated with the Company's new offices at Bedford and Smith Mountain Lake, Virginia.

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC - Form 10-Q

Other noninterest expense increased \$102,000 in the second quarter of 2008 compared to the same quarter of 2007.

For the first six months of 2008, noninterest expense was \$11.09 million, up 4.5% over the same period of 2007. The largest portion of the increase was due to a \$213,000 increase in the provision for unfunded lending commitments. The increase in salary expense is 0.9%. Increases in compensation have been largely offset by reductions in profit sharing and incentive compensation expense. Occupancy and equipment expense increased \$215,000. This increase was due primarily to investments in new operational technology, costs associated with the Company's new offices at Smith Mountain Lake and Bedford, Virginia, and costs associated with the termination of a lease.

| (in thousands) | Noninterest Expense | | | |
|--|---------------------|----------|------------------|-----------|
| | Three Months Ended | | Six Months Ended | |
| | June 30, | | June 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Salaries | \$ 2,481 | \$ 2,514 | \$ 4,950 | \$ 4,904 |
| Employee benefits | 777 | 737 | 1,524 | 1,385 |
| Occupancy and equipment | 928 | 850 | 1,894 | 1,679 |
| Bank franchise tax | 173 | 165 | 350 | 333 |
| Core deposit intangible amortization | 95 | 95 | 189 | 189 |
| Professional fees | 195 | 212 | 379 | 411 |
| Provision for unfunded lending commitments | 176 | (3) | 218 | 5 |
| Telephone | 109 | 90 | 210 | 182 |
| ATM network fees | 75 | 84 | 149 | 172 |
| Stationery and printing supplies | 76 | 100 | 144 | 178 |
| Postage | 34 | 64 | 127 | 135 |
| Trust services contracted | 73 | 53 | 123 | 103 |
| Advertising and marketing | 59 | 83 | 106 | 154 |
| Internet banking fees | 46 | 49 | 95 | 94 |
| Automobile | 42 | 36 | 71 | 63 |
| Contributions | 30 | 36 | 60 | 72 |
| Dues and subscriptions | 28 | 25 | 57 | 56 |
| Courier service | 28 | 26 | 53 | 52 |
| Loan expenses | 33 | 34 | 49 | 63 |
| Correspondent bank fees | 23 | 45 | 44 | 87 |
| FDIC assessment | 24 | 18 | 41 | 36 |
| Other | 138 | 135 | 259 | 265 |
| | \$ 5,643 | \$ 5,448 | \$ 11,092 | \$ 10,618 |

Income Taxes

During the second quarter of 2008, the Company eliminated its deferred tax valuation allowance related to its investments in FNMA and FHLMC preferred stock, which resulted in a \$125,000 reduction in income tax expense. As a result, the Company's 2008 effective tax rates are lower than the 2007 rates. The effective tax rate for the second quarter of 2008 was 22.3% compared to 29.0% for the same period of 2007. For the first six months of 2008, the effective tax rate was 26.5%, compared to 29.6% for the first six months of 2007. The effective tax rate is

lower than the statutory rate primarily due to 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.

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 portfolio consists primarily of high quality, investment-grade securities. Federal agency, mortgage-backed, and state and municipal securities comprise the majority of the portfolio.

The securities portfolio decreased from \$157,149,000 at December 31, 2007 to \$146,460,000 at June 30, 2008. The decrease was a result of other balance sheet changes during this period, including growth in loans and a decrease in deposits.

At June 30, 2008, mortgage-backed securities consist principally of obligations of U.S. Government agencies and sponsored entities. Mortgage-backed securities issued by non-U.S. Government agencies and sponsored entities had an amortized cost of \$3,392,000 and an estimated fair value of \$3,309,000; all are rated AAA as of June 30, 2008.

State and municipal bonds with an aggregate amortized cost of \$46,398,000 and an estimated fair value of \$46,612,000 at June 30, 2008, consisted of investment-grade obligations of various municipalities.

Corporate bonds with an aggregate amortized cost of \$1,485,000 and an aggregate estimated fair value of \$1,437,000 at June 30, 2008, consisted of two investment-grade bonds issued by financial firms.

An other-than-temporary impairment expense of \$255,000 on FHLMC preferred stock was charged to earnings during the quarter ended June 30, 2008. The market value of the securities dropped significantly, and any near-term recovery in value was considered uncertain as of June 30, 2008. The Company's recorded investment in these securities, after the impairment charge, was \$392,000 at June 30, 2008.

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. Loans not held for sale increased from \$551,391,000 at December 31, 2007 to \$568,830,000 at June 30, 2008.

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

The allowance for loan losses increased from \$7,395,000 at December 31, 2007 to \$7,932,000 at June 30, 2008. The allowance was 1.39% at June 30, 2008 as compared to 1.34% at December 31, 2007

Annualized net loan charge-offs represented 0.07% of average loans during the second quarter, well below industry averages. However, nonperforming assets increased \$3.68 million from year-end 2007 to June 30, 2008, primarily as a result of one residential construction and development loan relationship which became nonperforming due to the borrower's depleted liquidity and a decline in the market value of the real estate. The collateral consists of undeveloped and partially-developed land in the Triad area of North Carolina. The borrower recently submitted a proposed workout plan, which is being evaluated by American National and other creditors. American National has extended loans to the borrower totaling \$3.84 million, plus letters of credit in the amount of \$352,000 related to the development project. Largely as a result of this loan relationship, and to reflect greater overall loan loss potential due to current economic conditions, loan loss provision expense increased to \$600,000 during the second quarter of 2008, and \$740,000 for the first six months of the year. Loan loss provision expense was \$0 and \$303,000, respectively, in the second quarter and first six months of 2007. Additionally, the Company recorded an expense of \$175,000 during the quarter related to the estimated loss exposure on the aforementioned letters of credit. This expense is recorded with other noninterest expense. Loans 30-89 days past due remain well below industry averages, at 0.25% of loans as of June 30, 2008.

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 1.12% of total loans at June 30, 2008, and 0.48% at December 31, 2007. There were no troubled debt restructurings at June 30, 2008 or December 31, 2007.

The following table summarizes nonperforming assets (in thousands):

| | June 30, 2008 | December 31, 2007 |
|--------------------------------|------------------|-------------------------|
| Loans 90 days or more past due | \$ 172 | \$ - |
| Nonaccrual loans | 6,216 | 2,639 |
| Nonperforming loans | 6,388 | 2,639 |
| Foreclosed real estate | 558 | 632 |
| Nonperforming assets | \$ 6,946 | \$ 3,271 |

Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Deposits decreased from \$581,221,000 at December 31, 2007 to \$569,244,000 at June 30, 2008, due primarily to a decrease in time deposits. Deposits plus customer repurchase agreements decreased \$1,895,000, or 0.30% between the two dates. Deposit growth continues to be challenging in the banking industry due largely to intense competition for customer funds.

Shareholders' Equity

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

Shareholders' equity increased from \$101,511,000 at December 31, 2007 to \$101,896,000 at June 30, 2008. The increase was largely the result of net income and comprehensive income. These increases were partially offset by dividends and the effect of share repurchases. In the second quarter of 2008, the Company declared and paid a quarterly cash dividend of \$.23 per share.

One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Average shareholders' equity was 12.99% of average assets for the quarter ended June 30, 2008 and 12.61% for the quarter ended June 30, 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 shareholders' 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 June 30, 2008, the Company's Tier I and total capital ratios were 16.86% and 18.11%, respectively. At December 31, 2007, these ratios were 17.03% and 18.28%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 12.83% and 12.98% at June 30, 2008 and December 31, 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%, and leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of June 30, 2008, that the Company met the requirements to be considered "well capitalized."

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. Off-balance sheet transactions were as follows:

| | June 30, | December |
|----------------|----------|-------------|
| (in thousands) | 2008 | 31, 2007 |

| | | | | |
|-------------------------------------|----|---------|----|---------|
| Commitments to extend credit | \$ | 142,959 | \$ | 144,301 |
| Standby letters of credit | | 6,409 | | 6,222 |
| Mortgage loan rate-lock commitments | | 1,045 | | 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET 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 is asset sensitive.

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 manage 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 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. Based on the collateral pledged as of June 30, 2008, the total amount of borrowing available under the FHLB line of credit was approximately \$77,170,000. At June 30, 2008, principal obligations to the FHLB consisted of \$23,625,000 in floating-rate, overnight borrowings and \$13,863,000 in fixed-rate, long-term advances. FHLB borrowings were \$16,137,000 at December 31, 2007, consisting of \$7,200,000 in floating-rate, overnight borrowings and \$8,937,000 in fixed-rate, long-term advances.

The Company had fixed-rate term borrowing contracts with the FHLB as of June 30, 2008, with the following final maturities (in thousands):

| Amount | Expiration Date |
|-----------|-----------------|
| \$ 5,000 | April 2009 |
| 4,000 | March 2011 |
| 4,000 | April 2011 |
| 863 | March 2014 |
| \$ 13,863 | |

The Company has federal funds lines of credit established with two other banks in the amounts of \$15,000,000 and \$10,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at June 30, 2008.

There have been no material changes to market risk as disclosed in the Company's 2007 Annual Report on Form 10-K. Refer to those disclosures for further information.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief 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 June 30, 2008. Based on this evaluation, the Chief Executive Officer and Chief 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 June 30, 2008 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II

OTHER INFORMATION

Item:

1. Legal Proceedings

The nature of the business of the Company ordinarily results in a certain amount of litigation. The Company is involved in various legal proceedings, all of which are considered incidental to the normal conduct of business. Management believes that these proceedings will not have a material adverse effect on the consolidated financial position or consolidated results of operations of the Company.

Risk Factors

1A.

There have been no material changes to the risk factors disclosed in the Company's 2007 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2008.

2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases Made for the Quarter Ended June 30, 2008

| Dates | 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 |
|-----------------|---|---------------------------------------|---|---|
| April 1 - 30 | 2,400 | \$ 21.43 | 2,400 | 78,500 |
| May 1 - 31 | - | - | - | 78,500 |
| June 1 - 30 | - | - | - | 78,500 |

On August 22, 2007, the Company's board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 125,000 shares of the Company's common stock between August 22, 2007 and August 19, 2008. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Company.

Defaults Upon Senior Securities

3.

None

4. Submission of Matters to a Vote of Security Holders

At the Company's Annual Shareholders Meeting held on April 22, 2008, the following proposals were voted on:

Proposal 1

To elect three directors (Davis, Hudson, and Majors) to serve as Class III directors for a three-year term until 2011 and one director (Kent) to serve as a Class I director for a one-year term until 2009.

| | Votes | |
|-----------|-----------|----------|
| | Votes For | Withheld |
| H. Dan | | |
| Davis | 4,259,491 | 190,470 |
| Lester | | |
| A. | | |
| Hudson, | | |
| Jr., | | |
| Ph.D. | 4,166,853 | 283,108 |
| E. | | |
| Budge | | |
| Kent, Jr. | 4,262,982 | 186,979 |
| Charles | | |
| H. | | |
| Majors | 4,263,802 | 186,159 |

The following directors' terms of office continued after the 2007 annual meeting:

Fred A. Blair
Frank C. Crist, Jr., D.D.S
Ben J. Davenport, Jr.
Michael P. Haley
Fred B. Leggett, Jr.
Franklin W. Maddux, M.D.
Claude B. Owen, Jr.

Proposal 2

Approval of the 2008 Stock Incentive Plan

| | | | |
|------------|-----------|----------------|---------|
| Votes For: | 2,667,706 | Votes Against: | 248,772 |
|------------|-----------|----------------|---------|

5. Other Information

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

6. Exhibits

11. Refer to EPS calculation in the Notes to Financial Statements

31.1 Section 302 Certification of Charles H. Majors, President and Chief Executive Officer

31.2 Section 302 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer

32.1 Section 906 Certification of Charles H. Majors, President and Chief Executive Officer

32.2 Section 906 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer

SIGNATURES

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

AMERICAN NATIONAL BANKSHARES INC.

| | |
|-----------------------|---|
| Date – August 8, 2008 | /s/ Charles H. Majors Charles H. Majors President and Chief Executive Officer |
|-----------------------|---|

| | |
|-----------------------|--|
| Date – August 8, 2008 | /s/ Neal A. Petrovich Neal A. Petrovich Senior Vice President and Chief Financial Officer (Principal Accounting Officer) |
|-----------------------|--|