

AMERICAN NATIONAL BANKSHARES INC  
Form 10-Q  
November 09, 2011

---

---

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 September 30, 2011.

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

Commission file number: 0-12820

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

VIRGINIA  
(State or other jurisdiction of  
incorporation or organization)

54-1284688  
(I.R.S. Employer  
Identification No.)

628 Main Street  
Danville, Virginia  
(Address of principal executive offices)

24541  
(Zip Code)

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months.

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.

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 November 8, 2011 the Company had 7,802,976 shares of 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</u>   |           |
|                 | <u>Consolidated Balance Sheets as of September, 2011 and 3<br/>December 31, 2010</u>  | <u>3</u>  |
|                 | <u>Consolidated Statements of Income for the three months 4<br/>ended September, 2011 and 2010</u>                                | <u>4</u>  |
|                 | <u>Consolidated Statements of Income for the nine months 5<br/>ended September, 2011 and 2010</u>                                 | <u>5</u>  |
|                 | <u>Consolidated Statements of Changes in Shareholders' 6<br/>Equity for the nine months ended September 30, 2011<br/>and 2010</u> | <u>6</u>  |
|                 | <u>Consolidated Statements of Cash Flows for the nine 7<br/>months ended September 30, 2011 and 2010</u>                          | <u>7</u>  |
|                 | <u>Notes to Consolidated Financial Statements</u>   | <u>8</u>  |
| <u>Item 2.</u>  | <u>Management's Discussion and Analysis of Financial 33<br/>Condition and Results of Operations</u>                               | <u>33</u> |
| <u>Item 3.</u>  | <u>Quantitative and Qualitative Disclosures about Market 48<br/>Risk</u>  | <u>48</u> |
| <u>Item 4.</u>  | <u>Controls and Procedures</u>  | <u>49</u> |
| <u>Part II.</u> | <u>OTHER INFORMATION</u>  |           |
| <u>Item 1.</u>  | <u>Legal Proceedings</u>  | <u>50</u> |
| <u>Item 1A.</u> | <u>Risk Factors</u>   | <u>50</u> |
| <u>Item 2.</u>  | <u>Unregistered Sales of Equity Securities and Use of 50<br/>Proceeds</u>   | <u>50</u> |
| <u>Item 3.</u>  | <u>Defaults Upon Senior Securities</u>  | <u>50</u> |
| <u>Item 4.</u>  | <u>(Removed and Reserved)</u>   | <u>50</u> |

|                |                          |           |
|----------------|--------------------------|-----------|
| <u>Item 5.</u> | <u>Other Information</u> | <u>50</u> |
| <u>Item 6.</u> | <u>Exhibits</u>          | <u>51</u> |

SIGNATURES

2

---

IndexPart I. Financial Information  
Item 1. Financial StatementsAmerican National Bankshares Inc. and Subsidiaries  
Consolidated Balance Sheets  
(Dollars in thousands, except share data)

|  | (Unaudited)<br>September 30,<br>2011 | (Audited)<br>December<br>31,<br>2010 |
|--|--------------------------------------|--------------------------------------|
| <b>ASSETS</b>  |                                      |                                      |
| Cash and due from banks  | \$ 23,450                            | \$ 9,547                             |
| Interest-bearing deposits in other banks   | 30,086                               | 8,967                                |
| Securities available for sale, at fair value   | 311,517                              | 228,295                              |
| Securities held to maturity (fair value of \$2,450 at 9/30/11 and \$3,440 at 12/31/10) | 2,383                                | 3,334                                |
| Total securities   | 313,900                              | 231,629                              |
| Restricted stock, at cost  | 6,404                                | 4,062                                |
| Loans held for sale  | 3,359                                | 3,135                                |
| Loans, net of unearned income  | 817,858                              | 520,781                              |
| Less allowance for loan losses   | (9,086 )                             | (8,420 )                             |
| Net loans  | 808,772                              | 512,361                              |
| Premises and equipment, net  | 26,263                               | 19,509                               |
| Other real estate owned, net   | 5,920                                | 3,716                                |
| Goodwill   | 37,709                               | 22,468                               |
| Core deposit intangibles, net  | 7,142                                | 1,320                                |
| Accrued interest receivable and other assets   | 42,134                               | 16,950                               |
| Total assets   | \$ 1,305,139                         | \$ 833,664                           |
| <b>LIABILITIES and SHAREHOLDERS' EQUITY</b>  |                                      |                                      |
| Liabilities:   |                                      |                                      |
| Demand deposits -- noninterest bearing   | \$ 170,398                           | \$ 105,240                           |
| Demand deposits -- interest bearing  | 188,480                              | 90,012                               |
| Money market deposits  | 199,172                              | 59,891                               |
| Savings deposits   | 72,428                               | 62,522                               |
| Time deposits  | 433,999                              | 322,433                              |
| Total deposits   | 1,064,477                            | 640,098                              |

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

|   |              |            |
|---|--------------|------------|
| Short-term borrowings:  |              |            |
| Customer repurchase agreements  | 43,758       | 47,084     |
| Other short-term borrowings   | -            | 6,110      |
| Long-term borrowings  | 10,238       | 8,488      |
| Trust preferred capital notes   | 27,190       | 20,619     |
| Accrued interest payable and other liabilities  | 8,115        | 3,178      |
| Total liabilities   | 1,153,778    | 725,577    |
| Shareholders' equity:   |              |            |
| Preferred stock, \$5 par, 2,000,000 shares authorized,<br>1,000,000 shares of Series A preferred stock outstanding at September 30, 2011 and none issued at December 31, 2010 | 5,000        | -          |
| Common stock, \$1 par, 20,000,000 shares authorized,<br>7,802,976 shares outstanding at September 30, 2011 and<br>6,127,735 shares outstanding at December 31, 2010           | 7,803        | 6,128      |
| Capital in excess of par value  | 56,094       | 27,268     |
| Retained earnings   | 77,092       | 74,850     |
| Accumulated other comprehensive income (loss), net  | 5,372        | (159 )     |
| Total shareholders' equity  | 151,361      | 108,087    |
| Total liabilities and shareholders' equity  | \$ 1,305,139 | \$ 833,664 |

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

Index

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

|  | Three Months Ended<br>September 30 |              |
|--|------------------------------------|--------------|
|  | 2011                               | 2010         |
| <b>Interest and Dividend Income:</b>                           |                                    |              |
| Interest and fees on loans                                     | \$ 12,510                          | \$ 6,994     |
| <b>Interest and dividends on securities:</b>                   |                                    |              |
| Taxable  | 1,192                              | 1,253        |
| Tax-exempt   | 1,014                              | 621          |
| Dividends  | 35                                 | 24           |
| Other interest income  | 28                                 | 90           |
| <b>Total interest and dividend income</b>                      | <b>14,779</b>                      | <b>8,982</b> |
| <b>Interest Expense:</b>                                       |                                    |              |
| Interest on deposits   | 2,079                              | 1,722        |
| Interest on short-term borrowings                              | 82                                 | 93           |
| Interest on long-term borrowings                               | 86                                 | 65           |
| Interest on trust preferred capital notes                      | 189                                | 343          |
| <b>Total interest expense</b>                                  | <b>2,436</b>                       | <b>2,223</b> |
| <b>Net Interest Income</b>                                     | <b>12,343</b>                      | <b>6,759</b> |
| <b>Provision for Loan Losses</b>                               | <b>525</b>                         | <b>435</b>   |
| <b>Net Interest Income After Provision<br/>for Loan Losses</b> | <b>11,818</b>                      | <b>6,324</b> |
| <b>Noninterest Income:</b>                                     |                                    |              |
| Trust fees   | 921                                | 842          |
| Service charges on deposit accounts                            | 575                                | 478          |
| Other fees and commissions                                     | 429                                | 290          |
| Mortgage banking income  | 374                                | 428          |
| Securities gains, net  | -                                  | 67           |
| Other  | 399                                | 136          |
| <b>Total noninterest income</b>                                | <b>2,698</b>                       | <b>2,241</b> |
| <b>Noninterest Expense:</b>                                    |                                    |              |
| Salaries   | 3,676                              | 2,596        |
| Employee benefits  | 731                                | 564          |
| Occupancy and equipment  | 916                                | 732          |
| FDIC assessment  | 94                                 | 203          |
| Bank franchise tax   | 206                                | 168          |
| Core deposit intangible amortization                           | 545                                | 94           |
| Foreclosed real estate, net                                    | (261 )                             | (5 )         |
| Merger related expenses  | 390                                | -            |
| Other  | 2,267                              | 1,179        |
| <b>Total noninterest expense</b>                               | <b>8,564</b>                       | <b>5,531</b> |

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

|   |           |           |
|---|-----------|-----------|
| Income Before Income Taxes                  | 5,952     | 3,034     |
| Income Taxes                                | 1,823     | 806       |
| Net Income                                  | 4,129     | 2,228     |
| Dividends on preferred stock                | 51        | -         |
| Net income available to common shareholders | \$ 4,078  | \$ 2,228  |
| Net Income Per Common Share:                |           |           |
| Basic                                       | \$ 0.52   | \$ 0.36   |
| Diluted                                     | \$ 0.52   | \$ 0.36   |
| Average Common Shares Outstanding:          |           |           |
| Basic                                       | 7,800,614 | 6,125,359 |
| Diluted                                     | 7,806,668 | 6,131,129 |

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



Index

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

|  | Nine Months Ended<br>September 30 |               |
|--|-----------------------------------|---------------|
|  | 2011                              | 2010          |
| <b>Interest and Dividend Income:</b>                           |                                   |               |
| Interest and fees on loans                                     | \$ 25,807                         | \$ 21,220     |
| <b>Interest and dividends on securities:</b>                   |                                   |               |
| Taxable  | 3,446                             | 3,844         |
| Tax-exempt   | 2,557                             | 1,641         |
| Dividends  | 88                                | 71            |
| Other interest income  | 112                               | 268           |
| <b>Total interest and dividend income</b>                      | <b>32,010</b>                     | <b>27,044</b> |
| <b>Interest Expense:</b>                                       |                                   |               |
| Interest on deposits   | 5,246                             | 5,004         |
| Interest on short-term borrowings                              | 244                               | 297           |
| Interest on long-term borrowings                               | 144                               | 192           |
| Interest on trust preferred capital notes                      | 829                               | 1,030         |
| <b>Total interest expense</b>                                  | <b>6,463</b>                      | <b>6,523</b>  |
| <b>Net Interest Income</b>                                     | <b>25,547</b>                     | <b>20,521</b> |
| <b>Provision for Loan Losses</b>                               | <b>1,198</b>                      | <b>1,005</b>  |
| <b>Net Interest Income After Provision<br/>for Loan Losses</b> | <b>24,349</b>                     | <b>19,516</b> |
| <b>Noninterest Income:</b>                                     |                                   |               |
| Trust fees   | 2,727                             | 2,455         |
| Service charges on deposit accounts                            | 1,396                             | 1,440         |
| Other fees and commissions                                     | 1,083                             | 856           |
| Mortgage banking income  | 792                               | 1,017         |
| Securities gains (losses), net                                 | (18 )                             | 42            |
| Other  | 677                               | 398           |
| <b>Total noninterest income</b>                                | <b>6,657</b>                      | <b>6,208</b>  |
| <b>Noninterest Expense:</b>                                    |                                   |               |
| Salaries   | 8,707                             | 7,590         |
| Employee benefits  | 1,896                             | 1,837         |
| Occupancy and equipment  | 2,311                             | 2,209         |
| FDIC assessment  | 496                               | 597           |
| Bank franchise tax   | 557                               | 503           |
| Core deposit intangible amortization                           | 734                               | 283           |
| Foreclosed real estate, net                                    | 174                               | 279           |
| Merger related expenses  | 1,534                             | -             |
| Other  | 4,962                             | 3,607         |
| <b>Total noninterest expense</b>                               | <b>21,371</b>                     | <b>16,905</b> |

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

|   |           |           |
|---|-----------|-----------|
| Income Before Income Taxes                  | 9,635     | 8,819     |
| Income Taxes                                | 2,716     | 2,392     |
| Net Income                                  | 6,919     | 6,427     |
| Dividends on preferred stock                | 51        | -         |
| Net income available to common shareholders | \$ 6,868  | \$ 6,427  |
| Net Income Per Common Share:                |           |           |
| Basic                                       | \$ 1.02   | \$ 1.05   |
| Diluted                                     | \$ 1.02   | \$ 1.05   |
| Average Common Shares Outstanding:          |           |           |
| Basic                                       | 6,705,607 | 6,122,876 |
| Diluted                                     | 6,712,960 | 6,128,481 |

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

Index

American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
Nine Months Ended September 30, 2011 and 2010  
(Dollars in thousands) (Unaudited)

|   | Preferred<br>Stock | Common<br>Stock | Capital<br>in<br>Excess<br>of<br>Par<br>Value | Retained<br>Earnings | Accumulated                                |                                  |
|---|--------------------|-----------------|---|----------------------|--|----------------------------------|
|   |                    |                 |   |                      | Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
| Balance,<br>December 31,<br>2009  | \$ -               | \$ 6,110        | \$ 26,962                                     | \$ 72,208            | \$ 1,109                                   | \$ 106,389                       |
| Net income  | -                  | -               | -   | 6,427                | -  | 6,427                            |
| Change in<br>unrealized gains<br>on securities<br>available for<br>sale, net of tax,<br>\$1,105                 | -                  | -               | -   | -                    | 2,051                                      |                                  |
| Add: Reclassification<br>adjustment for losses<br>on impairment of<br>securities, net of<br>tax, \$11           | -                  | -               | -   | -                    | 20   |                                  |
| Less: Reclassification<br>adjustment for gains<br>on securities<br>available for sale,<br>net of<br>tax, \$(26) | -                  | -               | -   | -                    | (47 )                                      |                                  |
| Other<br>comprehensive<br>income  |                    |                 |   |                      | 2,024                                      | 2,024                            |
| Total<br>comprehensive<br>income  |                    |                 |   |                      |  | 8,451                            |
| Stock options<br>exercised  | -                  | 3               | 44  | -                    | -  | 47                               |

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

|  |       |          |           |           |          |            |
|--|-------|----------|-----------|-----------|----------|------------|
| Stock based compensation expense   | -     | -        | 47        | -         | -        | 47         |
| Equity based compensation  | -     | 13       | 147       | -         | -        | 160        |
| Cash dividends declared, \$0.69 per share  | -     | -        |           | (4,226)   | -        | (4,226)    |
| Balance, September 30, 2010  | \$ -  | \$ 6,126 | \$ 27,200 | \$ 74,409 | \$ 3,133 | \$ 110,868 |
| Balance, December 31, 2010   | \$ -  | \$ 6,128 | \$ 27,268 | \$ 74,850 | \$ (159) | \$ 108,087 |
| Net income   | -     | -        | -         | 6,919     |          | 6,919      |
| Change in unrealized gains on securities available for sale, net of tax, \$2,972               | -     | -        | -         | -         | 5,519    |            |
| Less: Reclassification adjustment for losses on securities available for sale, net of tax, \$6 | -     | -        | -         | -         | 12       |            |
| Other comprehensive income   |       |          |           |           | 5,531    | 5,531      |
| Total comprehensive income   |       |          |           |           |          | 12,450     |
| Issuance of common stock   |       | 1,626    | 28,279    |           | -        | 29,905     |
| Issuance of preferred stock  | 5,000 | -        | -         | -         | -        | 5,000      |
|  | -     | 11       | 162       | -         | -        | 173        |

Stock options  
exercised

|   |          |          |           |           |          |            |
|---|----------|----------|-----------|-----------|----------|------------|
| Stock based<br>compensation<br>expense          | -        | -        | 48        | -         | -        | 48         |
| Equity based<br>compensation                    | -        | 38       | 337       | -         | -        | 375        |
| Dividends on<br>preferred stock                 | -        | -        | -         | (51 )     | -        | (51 )      |
| Cash dividends<br>declared, \$0.69<br>per share | -        | -        | -         | (4,626 )  |          | (4,626 )   |
| Balance,<br>September 30,<br>2011               | \$ 5,000 | \$ 7,803 | \$ 56,094 | \$ 77,092 | \$ 5,372 | \$ 151,361 |

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

Index

American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Nine Months Ended September 30, 2011 and 2010  
(Dollars in thousands) (Unaudited)

|   | Nine Months Ended<br>September 30,<br>2011 | 2010      |
|---|--|-----------|
| Cash Flows from Operating   |  |           |
| Activities:   |  |           |
| Net income  | \$ 6,919                                   | \$ 6,427  |
| Adjustments to reconcile net income to net                          |  |           |
| cash provided by operating activities:                              |  |           |
| Provision for loan losses   | 1,198                                      | 1,005     |
| Depreciation  | 770  | 941       |
| Core deposit intangible amortization                                | 734  | 283       |
| Net amortization of securities                                      | 1,086                                      | 296       |
| Net (gain) loss on sale or call of securities                       | 18   | (73 )     |
| Impairment of securities  | -  | 31        |
| Gain on loans held for sale   | (95 )                                      | (902 )    |
| Proceeds from sales of loans held for sale                          | 31,901                                     | 36,195    |
| Originations of loans held for sale                                 | (31,917 )                                  | (36,755 ) |
| Net gain on foreclosed real estate                                  | (185 )                                     | (2 )      |
| Net change in valuation allowance on foreclosed real estate         | 359  | 281       |
| Stock-based compensation expense                                    | 48   | 47        |
| Equity based compensation   | 375  | 160       |
| Deferred income tax benefit   | (92 )                                      | (311 )    |
| Net change in interest receivable                                   | 825  | (451 )    |
| Net change in other assets  | 865  | 624       |
| Net change in interest payable                                      | (164 )                                     | (45 )     |
| Net change in other liabilities                                     | 1,263                                      | 432       |
| Net cash provided by operating activities                           | 13,908                                     | 8,183     |
| Cash Flows from Investing   |  |           |
| Activities:   |  |           |
| Proceeds from sales of securities available for sale                | 2,099                                      | 815       |
| Proceeds from sales of securities held to maturity                  | -  | 184       |
| Proceeds from maturities and calls of securities available for sale | 56,405                                     | 88,858    |
| Proceeds from maturities and calls of securities held to maturity   | 961  | 1,299     |
| Purchases of securities available for sale                          | (85,230 )                                  | (106,706) |

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

|  |                  |                  |
|--|------------------|------------------|
| Net change in loans                                      | 28,818           | 6,933            |
| Proceeds from sale of premises and equipment             | (114 )           | -                |
| Purchases of premises and equipment                      | (549 )           | (1,888 )         |
| Proceeds from sales of foreclosed real estate            | 1,896            | 156              |
| Purchases of foreclosed real estate                      | (51 )            | -                |
| Cash paid in bank acquisition                            | (12 )            | -                |
| Cash acquired in bank acquisition                        | 34,783           | -                |
| Net cash provided by (used in) investing activities      | 39,006           | (10,349 )        |
| <b>Cash Flows from Financing Activities:</b>             |                  |                  |
| Net change in demand, money market, and savings deposits | 31,502           | (27,079 )        |
| Net change in time deposits                              | (27,371 )        | 48,436           |
| Net change in repurchase agreements                      | (3,326 )         | (11,644 )        |
| Net change in short-term borrowings                      | (6,110 )         | -                |
| Net change in long-term borrowings                       | (8,108 )         | (113 )           |
| Net change in trust preferred capital notes              | 25               | -                |
| Common stock dividends paid                              | (4,626 )         | (4,226 )         |
| Preferred stock dividends paid                           | (51 )            | -                |
| Proceeds from exercise of stock options                  | 173              | 47               |
| Net cash (used in) provided by financing activities      | (17,892 )        | 5,421            |
| <b>Net Increase in Cash and Cash Equivalents</b>         | <b>35,022</b>    | <b>3,255</b>     |
| <b>Cash and Cash Equivalents at Beginning of Period</b>  | <b>18,514</b>    | <b>23,943</b>    |
| <b>Cash and Cash Equivalents at End of Period</b>        | <b>\$ 53,536</b> | <b>\$ 27,198</b> |

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

Index

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

Note 1 – Basis of Presentation

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

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate.

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

In July 2011, and in connection with its acquisition of MidCarolina Financial Corporation, the Company assumed the liabilities of the MidCarolina Statutory Trust I and II which was also formed for the purpose of issuing preferred securities. Refer to Note 9 for further details concerning these variable interest entities.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the Trust, as detailed in Note 9.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the Company’s financial position as of September 30, 2011; the consolidated statements of income for the three and nine months ended September 30, 2011 and 2010; the consolidated statements of changes in shareholders’ equity for the nine months ended September 30, 2011 and 2010; and the consolidated statements of cash flows for the nine months ended September 30, 2011 and 2010. Operating results for the three and nine month periods ended September 30, 2011 are not necessarily indicative of the results that may occur for the year ending December 31, 2011. Refer to Note 2 regarding the merger of MidCarolina Financial Corporation into American National Bankshares Inc. as of July 1, 2011. This transaction will be reported as of July 1 and prior periods will not be restated. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company’s Form 10-K for the year ended December 31, 2010.

Note 2 – Completed Merger

On July 1, 2011, American National Bankshares Inc. (“American National”) completed its merger with MidCarolina Financial Corporation (“MidCarolina”) pursuant to the Agreement and Plan of Reorganization, dated December 15, 2010, between American National and MidCarolina (the “merger agreement”). MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank. The



transaction has expanded the Company's footprint in North Carolina, adding eight branches in Alamance and Guilford Counties.

Pursuant to the terms of the merger agreement, as a result of the merger, the holders of shares of MidCarolina common stock received 0.33 shares of American National common stock for each share of MidCarolina common stock held immediately prior to the effective date of the merger. Each share of American National common stock outstanding immediately prior to the merger has continued to be outstanding after the merger. Each option to purchase a share of MidCarolina common stock outstanding immediately prior to the effective date of the merger was converted into an option to purchase shares of American National common stock, adjusted for the 0.33 exchange ratio. Additionally, the holders of shares of noncumulative perpetual Series A preferred stock of MidCarolina received one share of a newly authorized noncumulative perpetual Series A preferred stock of American National for each MidCarolina preferred share held immediately before the merger. The American National Series A preferred stock has terms, preferences, rights and limitations that are identical in all material respects to the MidCarolina Series A preferred stock.

Index

American National issued 1,626,157 shares of additional common stock in connection with the MidCarolina merger. This represents 20.9% of the now outstanding shares of American National.

In connection with the transaction, MidCarolina Bank was merged with and into American National Bank and Trust Company. The former offices of MidCarolina Bank are expected to operate under the name "MidCarolina Bank, a division of American National Bank and Trust Company" until early 2012.

The merger with MidCarolina was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration paid were recorded at their estimated fair values as of the merger date. The excess of consideration paid over the fair value of net assets acquired was recorded as goodwill in the amount of approximately \$15.2 million, which will not be amortizable and is not deductible for tax purposes. American National allocated the total balance of goodwill to its community banking segment. The Company also recorded \$6.5 million in core deposit intangibles which will be amortized over nine years using a declining balance method.

The fair values listed below are preliminary estimates and are subject to adjustment, however, while they are not expected to be materially different than those shown, any material adjustments to the estimates will be reflected, retroactively, as of the date of the merger.

In connection with the merger, the consideration paid, and the fair value of identifiable assets acquired and liabilities assumed as of the merger date are summarized in the following table:

(dollars in thousands)

Consideration Paid:

|                                  |           |
|----------------------------------|-----------|
| Common shares issued (1,626,157) | \$ 29,905 |
| Cash paid to Shareholders        | 12        |
| Preferred shares issued (5,000)  | 5,000     |
| Value of consideration           | 34,917    |

Assets acquired:

|                               |         |
|-------------------------------|---------|
| Cash and cash equivalents     | 34,783  |
| Investment securities         | 51,442  |
| Loans held for sale           | 113     |
| Loans, net of unearned income | 327,112 |
| Premises and equipment, net   | 6,861   |
| Deferred income taxes         | 15,626  |
| Core deposit intangible       | 6,556   |
| Other assets                  | 17,673  |
| Total assets                  | 460,166 |

Liabilities assumed:

|   |           |
|---|-----------|
| Deposits  | 420,248   |
| FHLB advances                                   | 9,858     |
| Other borrowings                                | 6,546     |
| Other liabilities                               | 3,838     |
| Total Liabilities                               | 440,490   |
| Net assets acquired                             | 19,676    |
| Goodwill resulting from merger with MidCarolina | \$ 15,241 |

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating the cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was that of acquired loans. The Company acquired the \$367.4 million loan portfolio at a fair value discount of \$40.3 million. The performing portion of the portfolio estimated fair value was \$289.2 million. The excess of expected cash flows above the fair value of the performing portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 310-20 (formerly SFAS 91).

Index

Certain loans, those for which specific credit-related deterioration, since origination, was identified, are recorded at fair value, reflecting the present value of the amounts expected to be collected. Income recognition on these loans is based on reasonable expectation about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretable yield.

The following tables details the acquired loans that are accounted for in accordance with FASB ASC 310-30 (formerly Statement of Position (“SOP”) 03-3) as of July 1, 2011:

|  |          |
|--|----------|
| Contractually required principal and interest at acquisition                   | \$56,869 |
| Contractual cash flows not expected to be collected (nonaccretable difference) | 15,433   |
| Expected cash flows at acquisition   | 41,436   |
| Interest component of expected cash flows (accretable discount)                | 3,547    |
| Fair value of acquired loans accounted for under FASB ASC 310-30               | \$37,889 |

In accordance with GAAP, there was no carryover of the allowance for loan losses that had been previously recorded by MidCarolina.

In connection with the merger with MidCarolina, the Company acquired an investment portfolio with a fair value of \$51.4 million. The fair value of the investment portfolio was determined by taking into account market prices obtained from independent valuation sources.

In connection with the merger with MidCarolina, the Company recorded a deferred income tax asset of \$15.6 million related to MidCarolina’s valuation allowance on foreclosed real estate and bad debt expenses, as well as other tax attributes of the acquired company, along with the effects of fair value adjustments resulting from applying the acquisition method of accounting.

The fair value of savings and transaction deposit accounts acquired from MidCarolina was assumed to approximate their carrying value as these accounts have no stated maturity and are payable on demand. Certificates of deposit accounts were valued by comparing the contractual cost of the portfolio to an identical portfolio bearing current market rates. The portfolio was segregated into pools based on segments: retail, Individual Retirement Accounts Brokered, and CDARs. For each segment, the projected cash flows from maturing certificates were then calculated based on contractual rates and prevailing market rates. The valuation adjustment for each segment is equal to the present value of the difference of these two cash flows, discounted at the assumed market rate for a certificate with a corresponding maturity. This valuation adjustment will be accreted to increase interest expense over the remaining maturities of the respective pools.

The fair value of the Federal Home Loan Bank of Atlanta (“FHLB”) advances was determined based on the discounted cash flows of further payments. This adjustment to the face value of the borrowings will be accreted to increase interest expense over the remaining lives of the respective borrowings.

Direct costs related to the acquisition were expensed as incurred. During the nine months ended September 30, 2011, the Company incurred \$1.5 million in merger and acquisition integration expenses related to the transaction, including \$1.3 million in professional services, \$130 thousand in technology and communications, \$22 thousand in advertising and marketing, and \$26 thousand in other non-interest expenses.

The following table presents unaudited pro forma information as if the merger with MidCarolina had occurred on January 1, 2010. This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments, amortization of core deposit and other intangibles and related income tax effects. It also reflects the removal of \$5.1 million in merger related expenses reflected on the books of both banks.

The pro forma information does not necessarily reflect the results of operations that would have occurred had the merger with MidCarolina occurred in 2010. In particular, expected operational cost savings are not reflected in the pro forma amounts.

Index

| (in thousands)                        | Pro forma<br>Nine Months Ended<br>September 30, |           |
|---------------------------------------|---|-----------|
|                                       | 2011  | 2010      |
| Net interest income                   | \$ 38,185                                       | \$ 37,925 |
| Provision for loan loss               | (3,598 )  | (6,023 )  |
| Non-interest income                   | 6,354   | 8,094     |
| Non-interest expense and income taxes | (31,635 )                                       | (31,022 ) |
| Net income                            | \$ 9,306  | \$ 8,974  |

## Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at September 30, 2011 and December 31, 2010 were as follows:

| (in thousands)                          | Amortized<br>Cost | September 30, 2011  |                      | Estimated<br>Fair Value |
|---|-------------------|---------------------|----------------------|-------------------------|
|   |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| Securities available for sale:          |                   |                     |                      |                         |
| Federal agencies & GSE                  | \$ 33,519         | \$ 734              | \$ -                 | \$ 34,253               |
| Mortgage-backed & private label<br>CMOs |                   |                     |                      |                         |
| State and municipal                     | 95,675            | 1,688               | 393                  | 96,970                  |
| Corporate                               | 169,548           | 8,405               | 44                   | 177,909                 |
| Total securities available for sale     | 2,301             | 84                  | -                    | 2,385                   |
|   | 301,043           | 10,911              | 437                  | 311,517                 |
| Securities held to maturity:            |                   |                     |                      |                         |
| State and municipal                     | 2,383             | 67                  | -                    | 2,450                   |
| Total securities held to maturity       | 2,383             | 67                  | -                    | 2,450                   |
| Total Securities                        | \$ 303,426        | \$ 10,978           | \$ 437               | \$ 313,967              |

| (in thousands)                          | Amortized<br>Cost | December 31, 2010   |                      | Estimated<br>Fair Value |
|---|-------------------|---------------------|----------------------|-------------------------|
|   |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| Securities available for sale:          |                   |                     |                      |                         |
| Federal agencies & GSE                  | \$ 57,292         | \$ 785              | \$ -                 | \$ 58,077               |
| Mortgage-backed & private label<br>CMOs |                   |                     |                      |                         |
| State and municipal                     | 62,128            | 1,273               | 419                  | 62,982                  |
| Corporate                               | 104,937           | 1,582               | 1,421                | 105,098                 |
| Total securities available for sale     | 1,974             | 164                 | -                    | 2,138                   |
|   | 226,331           | 3,804               | 1,840                | 228,295                 |
| Securities held to maturity:            |                   |                     |                      |                         |
| State and municipal                     | 3,334             | 106                 | -                    | 3,440                   |
| Total securities held to maturity       | 3,334             | 106                 | -                    | 3,440                   |
| Total Securities                        | \$ 229,665        | \$ 3,910            | \$ 1,840             | \$ 231,735              |

## Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2011. 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. Available for sale and held to maturity securities that have been in a continuous unrealized loss position are as follows:

| (in thousands)      | Total      |                 | Less than 12 Months |                 | 12 Months or More |                 |
|---------------------|------------|-----------------|---------------------|-----------------|-------------------|-----------------|
|                     | Estimated  |                 | Estimated           |                 | Estimated         |                 |
|                     | Fair Value | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| Mortgage-backed     | \$ 22,891  | \$ 183          | \$ 22,891           | \$ 183          | \$ -              | \$ -            |
| CMOs                | 8,907      | 210             | 8,809               | 193             | 98                | 17              |
| State and municipal | 2,580      | 44              | 2,580               | 44              | -                 | -               |
| Total               | \$ 34,378  | \$ 437          | \$ 34,280           | \$ 420          | \$ 98             | \$ 17           |

Index

Mortgage-backed securities: The unrealized losses on the Company's investment in 11 Government-Sponsored Enterprise ("GSE") mortgage-backed securities and one Government National Mortgage Association ("GNMA") mortgage-backed securities were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by a GSE or agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2011.

Collateralized Mortgage Obligations ("CMOs"): The unrealized loss associated with one private label residential CMO, with a book value of \$115,000, is primarily driven by higher projected collateral losses, wider credit spreads and changes in interest rates. We assess for credit impairment using a cash flow model when needed. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2011.

The unrealized loss associated with eight CMOs was caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2011.

State and municipal securities: The unrealized losses on the four investments in state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2011.

The Company's investment in FHLB stock totaled \$3,545,000 at September 30, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at September 30, 2011 and no impairment has been recognized. FHLB stock is shown in restricted stock on the balance sheet and is not a part of the available for sale securities portfolio.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2010.

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



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

|                     | Value     |          | Value     |          | Value  |        |
|---------------------|-----------|----------|-----------|----------|--------|--------|
| Mortgage-backed     | \$ 22,106 | \$ 216   | \$ 22,106 | \$ 216   | \$ -   | \$ -   |
| Private label CMOs  | 1,583     | 203      | 1,031     | 18       | 552    | 185    |
| State and municipal | 46,532    | 1,421    | 46,532    | 1,421    | -      | -      |
| Total               | \$ 70,221 | \$ 1,840 | \$ 69,669 | \$ 1,655 | \$ 552 | \$ 185 |

Other-Than-Temporary Impaired Securities

There were no other-than-temporary impaired securities held at September 30, 2011. One variable rate CMO which was impaired, held at December 31, 2010, was sold during the second quarter of 2011. During 2010, the Company had recognized an impairment charge to earnings of \$31,000. The sale during the second quarter of 2011 resulted in an additional loss of \$46,000.

Index

## Note 4 - Loans

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

| (in thousands)                    | September 30,<br>2011 | December 31,<br>2010 |
|-----------------------------------|-----------------------|----------------------|
| Commercial                        | \$ 133,731            | \$ 85,051            |
| Commercial real estate:           |                       |                      |
| Construction and land development | 53,723                | 37,168               |
| Commercial real estate            | 347,865               | 210,393              |
| Residential real estate:          |                       |                      |
| Residential                       | 172,454               | 119,398              |
| Home equity                       | 100,231               | 61,064               |
| Consumer                          | 9,854                 | 7,707                |
| Total loans                       | \$ 817,858            | \$ 520,781           |

Interest income on loans acquired from MidCarolina for the third quarter of 2011 was approximately \$6.0 million. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at September 30, 2011 are as follows:

| (in thousands)                | September 30,<br>2011 |
|-------------------------------|-----------------------|
| Outstanding principal balance | \$ 343,259            |
| Carrying amount               | 304,769               |

The outstanding principal balance and related carrying amount of acquired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), to account for interest earned, as of the indicated dates is as follows:

| (in thousands)                | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------|-----------------------|----------------------|
| Outstanding principal balance | \$ 55,113             | \$ 390               |
| Carrying amount               | 36,502                | 166                  |

The following table presents changes in the accretable discount on acquired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), for the nine months ended September 30, 2011.

| (in thousands)                        | Accretable<br>Discount |
|---------------------------------------|------------------------|
| Balance at December 31, 2010          | \$ 27                  |
| Recorded at acquisition, July 1, 2011 | 3,547                  |
| Accretion                             | (580 )                 |
| Balance at September 30, 2011         | \$ 2,994               |



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

The following table shows an analysis by portfolio class of the Company's past due loans at September 30, 2011 and December 31, 2010. It is the operating policy of the Company that any loan past due 90 days will be transferred to nonaccrual loan status, therefore there are no loans reported in the 90 days and accruing column below.

| At September 30, 2011                   |                            |                              | 90   | Non-<br>Accrual<br>Loans | Total<br>Past<br>Due | Current    | Total<br>Loans |
|---|----------------------------|------------------------------|--|--------------------------|----------------------|------------|----------------|
|   | 30- 59<br>Days<br>Past Due | 60-89<br>Days<br>Past<br>Due | Days<br>+<br>Past<br>Due<br>and<br>Still<br>Accruing |                          |                      |            |                |
| (in thousands)                          | Past Due                   | Due                          | Loans  | Loans                    | Due                  |            | Loans          |
| Commercial                              | \$ 154                     | \$ 275                       | \$ -   | \$ 1,840                 | \$ 2,269             | \$ 131,462 | \$ 133,731     |
| Commercial<br>real estate:              |                            |                              |  |                          |                      |            |                |
| Construction<br>and land<br>development | 187                        | 292                          | -  | 6,669                    | 7,148                | 46,575     | 53,723         |
| Commercial<br>real estate               | 2,001                      | 32                           | -  | 1,331                    | 3,364                | 344,501    | 347,865        |
| Residential:                            |                            |                              |  |                          |                      |            |                |
| Residential                             | 554                        | 89                           | -  | 3,499                    | 4,142                | 168,312    | 172,454        |
| Home equity                             | 231                        | 70                           | -  | 56                       | 357                  | 99,874     | 100,231        |
| Consumer:                               |                            |                              |  |                          |                      |            |                |
| Consumer                                | 35                         | 16                           | -  | 60                       | 111                  | 9,743      | 9,854          |
| Total                                   | \$ 3,162                   | \$ 774                       | \$ -   | \$ 13,455                | \$ 17,391            | \$ 800,467 | \$ 817,858     |

| At December 31, 2010                    |                            |                           | 90   | Non-<br>Accrual<br>Loans | Total<br>Past<br>Due | Current   | Total<br>Loans |
|---|----------------------------|---------------------------|--|--------------------------|----------------------|-----------|----------------|
|   | 30- 59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | Days<br>+<br>Past<br>due<br>and<br>Still<br>Accruing |                          |                      |           |                |
| (in thousands)                          | Past Due                   | Past Due                  | Loans  | Loans                    | Due                  |           | Loans          |
| Commercial                              | \$ -                       | \$ 46                     | \$ -   | \$ 401                   | \$ 447               | \$ 84,604 | \$ 85,051      |
| Commercial<br>real estate:              |                            |                           |  |                          |                      |           |                |
| Construction<br>and land<br>development | -                          | 40                        | -  | 59                       | 99                   | 37,069    | 37,168         |
| Commercial<br>real estate               | 572                        | 175                       | -  | 614                      | 1,361                | 209,032   | 210,393        |
| Residential:                            |                            |                           |  |                          |                      |           |                |
| Residential                             | 742                        | 704                       | -  | 1,419                    | 2,865                | 116,533   | 119,398        |

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

|             |          |          |      |          |          |            |            |
|-------------|----------|----------|------|----------|----------|------------|------------|
| Home equity | 15       | 23       | -    | 97       | 135      | 60,929     | 61,064     |
| Consumer:   |          |          |      |          |          |            |            |
| Consumer    | 8        | 72       | -    | 7        | 87       | 7,620      | 7,707      |
| Total       | \$ 1,337 | \$ 1,060 | \$ - | \$ 2,597 | \$ 4,994 | \$ 515,787 | \$ 520,781 |

Index

The following table presents the Company's impaired loan balances by portfolio class at September 30, 2011.

| (in thousands)                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ -                   | \$ -                           | \$ -                 | \$ 64                             | \$ -                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 771                    | 794                            | -                    | 324                               | -                                |
| Commercial real estate              | 162                    | 162                            | -                    | 211                               | -                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 513                    | 569                            | -                    | 326                               | -                                |
| Home equity                         | 170                    | 170                            | -                    | 19                                | -                                |
| Consumer:                           |                        |                                |                      |                                   |                                  |
| Consumer                            | 56                     | 59                             | -                    | 6                                 | -                                |
| With an related allowance recorded: |                        |                                |                      |                                   |                                  |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 175                    | 175                            | 44                   | 19                                | -                                |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ -                   | \$ -                           | \$ -                 | \$ 64                             | \$ -                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 771                    | 794                            | -                    | 324                               | -                                |
| Commercial real estate              | 162                    | 162                            | -                    | 211                               | -                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 688                    | 744                            | 44                   | 345                               | -                                |
| Home equity                         | 170                    | 170                            | -                    | 19                                | -                                |
| Consumer:                           |                        |                                |                      |                                   |                                  |
| Consumer                            | 56                     | 59                             | -                    | 6                                 | -                                |

Index

The following table presents the Company's impaired loan balances by portfolio class at December 31, 2010.

| (in thousands)                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 231                 | \$ 240                         | \$ -                 | \$ 531                            | \$ 9                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 329                    | 355                            | -                    | 1,291                             | 7                                |
| Commercial real estate              | -                      | -                              | -                    | -                                 | -                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | -                      | -                              | -                    | 681                               | 1                                |
| Home equity                         | -                      | -                              | -                    | -                                 | -                                |
| Consumer:                           |                        |                                |                      |                                   |                                  |
| Consumer                            | -                      | -                              | -                    | -                                 | -                                |
| With an related allowance recorded: |                        |                                |                      |                                   |                                  |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | -                      | -                              | -                    | -                                 | -                                |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 231                 | \$ 240                         | \$ -                 | \$ 531                            | \$ 9                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 329                    | 355                            | -                    | 1,291                             | 7                                |
| Commercial real estate              | -                      | -                              | -                    | -                                 | -                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | -                      | -                              | -                    | 681                               | 1                                |
| Home equity                         | -                      | -                              | -                    | -                                 | -                                |
| Consumer:                           |                        |                                |                      |                                   |                                  |
| Consumer                            | -                      | -                              | -                    | -                                 | -                                |

The following table shows the detail of loans modified as Troubled Debt Restructurings ("TDRs") included in the impaired loan balances for the three and nine months ended September 30, 2011.

| (dollars in thousands)  | Loans Modified as a TDR for the<br>Three Months Ended September 30, 2011 |   |  | Loans Modified as a TDR for the<br>Nine Months Ended September 30, 2011 |   |  |
|-------------------------|--|---|--|---|---|--|
|                         | Number<br>of<br>Contracts  | Recorded<br>Investment<br>(as of<br>period end) | Increase in<br>the<br>Allowance<br>(as of<br>period end) | Number<br>of<br>Contracts   | Recorded<br>Investment<br>(as of period<br>end) | Increase in<br>the<br>Allowance<br>(as of<br>period end) |
| Commercial              | -  | \$ -  | \$ -   | -   | \$ -  | \$ -   |
| Commercial real estate: |  |   |  |   |   |  |
|                         | -  | -   | -  | 3   | 335   | -  |

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

|                                   |   |       |      |   |        |      |  |
|-----------------------------------|---|-------|------|---|--------|------|--|
| Construction and land development |   |       |      |   |        |      |  |
| Other                             | 1 | 44    | -    | 1 | 44     | -    |  |
| Residential:                      |   |       |      |   |        |      |  |
| Residential Home                  | - | -     | -    | 1 | 291    | -    |  |
| Equity                            | - | -     | -    | - | -      | -    |  |
| Consumer                          | - | -     | -    | - | -      | -    |  |
| Total                             | 1 | \$ 44 | \$ - | 5 | \$ 670 | \$ - |  |

None of the loans modified as a TDR within the previous twelve months have subsequently defaulted during the three and nine month periods ending September 30, 2011.



Index

The following table shows the Company's loan portfolio broken down by internal risk grading.

Credit Quality Indicators  
As of September 30, 2011  
(in thousands)

Commercial and Consumer Credit  
Exposure  
Credit Risk Profile by Internally  
Assigned Grade

|                 | Commercial | Commercial<br>Real<br>Estate<br>Construction | Commercial<br>Real<br>Estate<br>Other | Residential | Home<br>Equity |
|-----------------|------------|--|---------------------------------------|-------------|----------------|
| Pass            | \$ 130,346 | \$ 36,091                                    | \$ 325,842                            | \$ 152,795  | \$ 97,091      |
| Special Mention | 1,302      | 1,985  | 17,924                                | 12,023      | 1,703          |
| Substandard     | 2,083      | 15,647                                       | 4,099                                 | 7,636       | 1,437          |
| Doubtful        | -          | -  | -                                     | -           | -              |
| Total           | \$ 133,731 | \$ 53,723                                    | \$ 347,865                            | \$ 172,454  | \$ 100,231     |

Consumer Credit  
Exposure  
Credit Risk Profile Based on Payment  
Activity

|               | Consumer |
|---------------|----------|
| Performing    | \$ 9,610 |
| Nonperforming | 244      |
| Total         | \$ 9,854 |

Credit Quality Indicators  
As of December 31, 2010  
(in thousands)

Commercial and Consumer Credit  
Exposure  
Credit Risk Profile by Internally  
Assigned Grade

|  | Commercial | Commercial<br>Real<br>Estate<br>Construction | Commercial<br>Real<br>Estate<br>Other | Residential | Home<br>Equity |
|--|------------|--|---------------------------------------|-------------|----------------|
|--|------------|--|---------------------------------------|-------------|----------------|

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

|                 |           |           |            |            |           |
|-----------------|-----------|-----------|------------|------------|-----------|
| Pass            | \$ 83,693 | \$ 31,868 | \$ 196,668 | \$ 107,351 | \$ 59,604 |
| Special Mention | 844       | 1,669     | 8,387      | 8,350      | 1,150     |
| Substandard     | 514       | 3,631     | 5,338      | 3,697      | 310       |
| Doubtful        | -         | -         | -          | -          | -         |
| Total           | \$ 85,051 | \$ 37,168 | \$ 210,393 | \$ 119,398 | \$ 61,064 |

Consumer Credit  
 Exposure  
 Credit Risk Profile Based on Payment  
 Activity

| Consumer      |          |
|---------------|----------|
| Performing    | \$ 7,423 |
| Nonperforming | 284      |
| Total         | \$ 7,707 |

Index

Loans classified in the Pass category typically are fundamentally sound and risk factors are reasonable and acceptable.

Loans classified in the Special Mention category typically have been criticized internally, by loan review or the loan officer, or by external regulators under the current credit policy regarding risk grades.

Loans classified in the substandard category typically have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are typically characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Loans classified in the Doubtful category typically have all the weaknesses inherent in loans classified as substandard, plus the added characteristic the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur that may salvage the debt.

Consumer loans are classified as performing or nonperforming. A loan is nonperforming when payments of interest and principal are past due 90 days or more; or payments are less than 90 days past due, but there are other good reasons to doubt that payment will be made in full.

Other real estate owned was \$5,920,000 at September 30, 2011 and \$3,716,000 December 31, 2010.

## 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 nine months ended September 30, 2011 and 2010, and for the year ended December 31, 2010, are presented below:

| (in thousands)                                      | Nine Months<br>Ended<br>September 30,<br>2011 | Year Ended<br>December 31,<br>2010 | Nine Months<br>Ended<br>September 30,<br>2010 |
|---|---|------------------------------------|---|
| <b>Allowance for Loan Losses</b>                    |   |                                    |   |
| Balance, beginning of period                        | \$ 8,420                                      | \$ 8,166                           | \$ 8,166                                      |
| Provision for loan losses                           | 1,198   | 1,490                              | 1,005   |
| Charge-offs   | (957 )  | (1,531 )                           | (869 )  |
| Recoveries  | 425   | 295                                | 240   |
| Balance, end of period                              | \$ 9,086                                      | \$ 8,420                           | \$ 8,542                                      |
| <b>Reserve for Unfunded Lending<br/>Commitments</b> |   |                                    |   |
| Balance, beginning of period                        | \$ 218  | \$ 260                             | \$ 260  |
| Provision for loan losses                           | (15 )   | (42 )                              | (30 )   |
| Charge-offs   | -   | -                                  | -   |
| Balance, end of period                              | \$ 203  | \$ 218                             | \$ 230  |

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



Index

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment.

|                                  | Commercial | Commercial<br>Real Estate | Residential<br>Real Estate | Consumer | Total    |
|----------------------------------|------------|---------------------------|----------------------------|----------|----------|
| (in thousands)                   |            |                           |                            |          |          |
| Allowance for Loan Losses        |            |                           |                            |          |          |
| Balance as of December 31, 2010  | \$ 751     | \$ 4,631                  | \$ 2,921                   | \$ 117   | \$ 8,420 |
| Charge-offs                      | (132 )     | (426 )                    | (330 )                     | (69 )    | (957 )   |
| Recoveries                       | 316        | 10                        | 44                         | 55       | 425      |
| Provision                        | 43         | 413                       | 674                        | 68       | 1,198    |
| Balance as of September 30, 2011 | \$ 978     | \$ 4,628                  | \$ 3,309                   | \$ 171   | \$ 9,086 |

Balances at September 30, 2011:

|                                       |        |          |          |        |          |
|---------------------------------------|--------|----------|----------|--------|----------|
| Allowance for Loan Losses             |        |          |          |        |          |
| Individually evaluated for impairment | \$ -   | \$ -     | \$ 44    | \$ -   | \$ 44    |
| Collectively evaluated for impairment | 978    | 4,628    | 3,265    | 171    | 9,042    |
| Total                                 | \$ 978 | \$ 4,628 | \$ 3,309 | \$ 171 | \$ 9,086 |

|   |            |            |            |          |            |
|---|------------|------------|------------|----------|------------|
| Loans   |            |            |            |          |            |
| Individually evaluated for impairment           | \$ -       | \$ 933     | \$ 858     | \$ 56    | \$ 1,847   |
| Collectively evaluated for impairment           | 128,883    | 380,630    | 260,199    | 9,798    | 779,510    |
| Loans acquired with deteriorated credit quality | 4,848      | 20,024     | 11,629     | -        | 36,501     |
| Total   | \$ 133,731 | \$ 401,587 | \$ 272,686 | \$ 9,854 | \$ 817,858 |

Balances at December 31, 2010:

|                                       |        |          |          |        |          |
|---------------------------------------|--------|----------|----------|--------|----------|
| Allowance for Loan Losses             |        |          |          |        |          |
| Individually evaluated for impairment | \$ -   | \$ -     | \$ -     | \$ -   | \$ -     |
| Collectively evaluated for impairment | 751    | 4,631    | 2,921    | 117    | 8,420    |
| Total                                 | \$ 751 | \$ 4,623 | \$ 2,929 | \$ 117 | \$ 8,420 |

Loans

|   |           |            |            |          |            |
|---|-----------|------------|------------|----------|------------|
| Individually evaluated for impairment           | \$ 231    | \$ 329     | \$ -       | \$ -     | \$ 560     |
| Collectively evaluated for impairment           | 84,820    | 247,103    | 180,399    | 7,707    | 520,029    |
| Loans acquired with deteriorated credit quality | -         | 129        | 63         | -        | 192        |
| Total   | \$ 85,051 | \$ 247,561 | \$ 180,462 | \$ 7,707 | \$ 520,781 |

#### Note 6 – Goodwill and Other Intangible Assets

In January 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (ASC 805), “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 2011 that determined there has been no impairment in the value of goodwill.

The goodwill and core deposit intangible balances presented below resulted from the acquisition of MidCarolina on July 1, 2011 and the acquisition of Community First in April of 2006. For further information regarding the goodwill and other intangible assets recorded in connection with the acquisition of MidCarolina, please refer to note 2, above.

Index

The changes in the carrying amount of goodwill for the nine months ended September 30, 2011, are as follows:

| (in thousands)             | Goodwill  | Intangibles |
|----------------------------|-----------|-------------|
| Balance December 31, 2010  | \$ 22,468 | \$ 1,320    |
| Additions                  | 15,241    | 6,556       |
| Amortization               | -         | (734 )      |
| Impairment                 | -         | -           |
| Balance September 30, 2011 | \$ 37,709 | \$ 7,142    |

## Note 7 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following as of September 30, 2011 and December 31, 2010 (in thousands):

|                                | September 30,<br>2011 | December 31,<br>2010 |
|--------------------------------|-----------------------|----------------------|
| Customer repurchase agreements | \$ 43,758             | \$ 47,084            |
| FHLB overnight borrowings      | -                     | 6,110                |
|                                | \$ 43,758             | \$ 53,194            |

## Note 8 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of September 30, 2011, \$434,900,000 in loans was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of September 30, 2011 and December 31, 2010 (dollars in thousands):

| Due by        | September 30, 2011 |                             |  | December 31, 2010 |                   |                             |
|---------------|--------------------|-----------------------------|--|-------------------|-------------------|-----------------------------|
|               | Advance<br>Amount  | Weighted<br>Average<br>Rate |  | Due by            | Advance<br>Amount | Weighted<br>Average<br>Rate |
| April 2014    | \$ 375             | 3.78 %                      |  | March 2011        | \$ 8,000          | 2.93 %                      |
| November 2017 | 9,863              | 2.98                        |  | April 2014        | 488               | 3.78                        |
|               | \$ 10,238          | 3.01 %                      |  |                   | \$ 8,488          | 2.98 %                      |

The advance due in November of 2017 is net of a valuation allowance \$137,000. The original valuation allowance recorded on July 1, 2011 was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the States of Virginia and North Carolina. At September 30, 2011, the Company's public deposits totaled \$122,704. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At September 30, 2011, the Company had \$72 million in letters of credit with the FHLB outstanding to provide collateral for such deposits.



Index

## Note 9 – Trust Preferred Capital Notes

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a newly formed, wholly owned subsidiary of the Company, issued \$20,000,000 of preferred securities in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company's option beginning on June 30, 2011. The securities required initially quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate reset quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to 20 consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of \$619,000 received by the Trust from the issuance of common securities by the Trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a Junior Subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company, and for general corporate purposes.

On July 1, 2011, in connection with the MidCarolina merger, the Company assumed \$8,764,000 in Junior Subordinated debentures to MidCarolina Trust I and II (together, the "MidCarolina Trusts"), to fully and unconditionally guarantee the preferred securities issued by the MidCarolina Trusts. These long term obligations, which currently qualify as Tier I capital, constitute and full and unconditional guarantee by the Company of the MidCarolina Trusts' obligations. The MidCarolina Trusts are not consolidated in the Company's financial statements.

In accordance with FASB ASC 810-10-15-14, the Company did not eliminate through consolidation the Company's \$619,000 equity investment in AMNB Statutory Trust I or the \$264,000 equity investment in the MidCarolina Trusts. Instead, the Company reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

A description of the Junior Subordinated debt securities outstanding payable to the trusts as of September 30, 2011 and December 31, 2010 are shown below:

| Issuing Entity | Issued   | Rate                       | Date     | 2011      | 2010      |
|----------------|----------|----------------------------|----------|-----------|-----------|
| AMNB I         | 04-07-06 | Libor<br>plus<br>1.35<br>% | 06-30-36 | \$ 20,619 | \$ 20,619 |
| MidCarolina I  | 10-29-02 | Libor<br>plus<br>3.45<br>% | 11-07-32 | 3,972     | -         |
| MidCarolina II | 12-03-03 | Libor<br>plus<br>2.90<br>% | 10-07-33 | 2,599     | -         |

\$ 27,190 \$ 20,619

The principal amounts reflected for the MidCarolina I and the MidCarolina II are net of valuation allowances of \$1,183,000 and \$1,010,000 respectively. The original valuation allowances of \$1,197,000 and \$1,032,000 were recorded as a result of the merger with MidCarolina on July 1, 2011.

Index

## Note 10 – Stock Based Compensation

The Company's 2008 Stock Incentive Plan ("2008 Plan") was adopted by the Board of Directors of the Company on February 19, 2008 and approved by shareholders on April 22, 2008 at the Company's 2008 Annual Meeting of Shareholders. The 2008 Plan provides for the granting of restricted stock awards and incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board of Directors or a Board designated committee. The 2008 Plan authorizes the issuance of up to 500,000 shares of common stock. The 2008 Plan replaced the Company's stock option plan that was approved by the shareholders at the 1997 Annual Meeting, which plan terminated in 2006.

## Stock Options

A summary of stock option transactions for the nine months ended September 30, 2011, is as follows:

|                                   | Option<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Average<br>Intrinsic<br>Value<br>(\$000) |
|-----------------------------------|------------------|--|---|--|
| Outstanding at December 31, 2010  | 159,499          | \$ 21.48                                 |   |  |
| Acquired in acquisition           | 120,312          | 26.54                                    |   |  |
| Granted                           | -                | -  |   |  |
| Exercised                         | (10,522 )        | 16.45                                    |   |  |
| Forfeited                         | (650 )           | 22.69                                    |   |  |
| Outstanding at September 30, 2011 | 268,639          | \$ 23.94                                 | 4.7   | \$ 60                                    |
| Exercisable at September 30, 2011 | 240,750          | \$ 24.38                                 |   | \$ 42                                    |

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. As of September 30, 2011, there was \$16,000 in total unrecognized compensation expense related to nonvested stock option grants.

## Restricted Stock

The Company from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company's common stock. The value of the stock awarded is established as the fair market value of the common stock at the time of the grant. The Company recognizes expenses, equal to the total value of such awards, ratably over the vesting period of the stock grants.

The Company made its second restricted grant to executive officers in the first quarter 2011. These grants cliff vest over a 24-month period. On January 18, 2011, the Company issued 12,830 shares of restricted stock to its six executive officers and four regional executives.

Nonvested restricted stock for the nine months ended September 30, 2011 is summarized in the following table.

| Restricted Stock                | Shares | Grant date<br>fair value |
|---------------------------------|--------|--------------------------|
| Nonvested at December 31, 2010  | 8,712  | \$ 21.36                 |
| Granted                         | 12,830 | 22.77                    |
| Vested                          | -      | -                        |
| Forfeited                       | -      | -                        |
| Nonvested at September 30, 2011 | 21,542 | \$ 22.19                 |

As of September 30, 2011, there was \$206,000 of total unrecognized compensation cost related to nonvested restricted stock granted under the plan. This cost is expected to be recognized over the next 15 months.

Starting in 2010, the Company began offering its directors an option on director compensation. Their regular monthly retainer could be received as \$1,000 per month in cash or \$1,250 in immediately vested, but restricted stock. In 2011, monthly meeting fees could also be received as \$400 per month in cash or \$500 in immediately vested, but restricted stock. For the first nine months of 2011, 13 15 directors elected to receive stock in lieu of cash for their retainer and meeting fees. Only outside directors receive board fees. The Company issued 8,925 and 4,472 shares and recognized share based compensation expense of \$170,000 and \$90,000 during first nine months of 2011 and 2010, respectively.

Index

## Note 11 – 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<br>September 30, |                        |           |                        |
|--|-------------------------------------|------------------------|-----------|------------------------|
|  | 2011                                |                        | 2010      |                        |
|  | Shares                              | Per<br>Share<br>Amount | Shares    | Per<br>Share<br>Amount |
| Basic  | 7,800,614                           | \$ 0.52                | 6,125,359 | \$ 0.36                |
| Effect of dilutive securities -<br>stock options | 6,054                               | -                      | 5,770     | -                      |
| Diluted  | 7,806,668                           | \$ 0.52                | 6,131,129 | \$ 0.36                |

|  | Nine Months Ended<br>September 30, |                        |           |                        |
|--|------------------------------------|------------------------|-----------|------------------------|
|  | 2011                               |                        | 2010      |                        |
|  | Shares                             | Per<br>Share<br>Amount | Shares    | Per<br>Share<br>Amount |
| Basic  | 6,705,607                          | \$ 1.02                | 6,122,876 | \$ 1.05                |
| Effect of dilutive securities -<br>stock options | 7,353                              | -                      | 5,605     | -                      |
| Diluted  | 6,712,960                          | \$ 1.02                | 6,128,481 | \$ 1.05                |

Stock options on common stock, which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2011 and 2010 because their effects were antidilutive, averaged 114,081 and 82,627, respectively.

## Note 12 – Employee Benefit Plans

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

| Components of Net Periodic Benefit<br>Cost<br>(in thousands) | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2011                                | 2010   | 2011                               | 2010   |
|  | Service cost                        | \$ 27  | \$ 23                              | \$ 81  |
| Interest cost  | 101                                 | 117    | 303                                | 351    |
| Expected return on plan assets                               | (131 )                              | (135 ) | (393 )                             | (405 ) |
| Recognized net actuarial loss                                | 40                                  | 57     | 120                                | 171    |
| Net periodic benefit cost                                    | \$ 37                               | \$ 62  | \$ 111                             | \$ 186 |

The Company's does not anticipate contributing to the plan for 2011.



Index

Note 13 – Segment and Related Information

The Company has two reportable segments, Community banking and trust and investment services.

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

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

Amounts shown in the “Other” column includes activities of American National Bankshares Inc. which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of American National Bankshares Inc.’s interest income on deposits held by its banking subsidiary.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Index

Segment information as of and for the three and nine month periods ended September 30, 2011 and 2010, is shown in the following table.

| (in thousands)                   | Three Months Ended September 30, 2011 |                                     |        |                              |           |
|----------------------------------|---------------------------------------|-------------------------------------|--------|------------------------------|-----------|
|                                  | Community<br>Banking                  | Trust and<br>Investment<br>Services | Other  | Intersegment<br>Eliminations | Total     |
| Interest income                  | \$ 14,779                             | \$ -                                | \$ 16  | \$ (16 )                     | \$ 14,779 |
| Interest expense                 | 2,288                                 | -                                   | 164    | (16 )                        | 2,436     |
| Noninterest income               | 1,657                                 | 1,036                               | 5      | -                            | 2,698     |
| Income before income<br>taxes    | 5,720                                 | 663                                 | (431 ) | -                            | 5,952     |
| Net income                       | 4,087                                 | 438                                 | (396 ) | -                            | 4,129     |
| Depreciation and<br>amortization | 712                                   | 5                                   | -      | -                            | 722       |
| Total assets                     | 1,304,236                             | -                                   | 903    | -                            | 1,305,139 |
| Capital expenditures             | 300                                   | -                                   | -      | -                            | 300       |

|                                  | Three Months Ended September 30, 2010 |                                     |        |                              |          |
|----------------------------------|---------------------------------------|-------------------------------------|--------|------------------------------|----------|
|                                  | Community<br>Banking                  | Trust and<br>Investment<br>Services | Other  | Intersegment<br>Eliminations | Total    |
| Interest income                  | \$ 8,982                              | \$ -                                | \$ 29  | \$ (29 )                     | \$ 8,982 |
| Interest expense                 | 1,909                                 | -                                   | 343    | (29 )                        | 2,223    |
| Noninterest income               | 1,359                                 | 872                                 | 10     | -                            | 2,241    |
| Income before income<br>taxes    | 2,796                                 | 579                                 | (341 ) | -                            | 3,034    |
| Net income                       | 2,071                                 | 382                                 | (225 ) | -                            | 2,228    |
| Depreciation and<br>amortization | 394                                   | 5                                   | -      | -                            | 399      |
| Total assets                     | 823,582                               | -                                   | 635    | -                            | 824,217  |
| Capital expenditures             | 789                                   | -                                   | -      | -                            | 789      |

|                                  | Nine Months Ended September 30, 2011 |                                     |          |                              |           |
|----------------------------------|--------------------------------------|-------------------------------------|----------|------------------------------|-----------|
|                                  | Community<br>Banking                 | Trust and<br>Investment<br>Services | Other    | Intersegment<br>Eliminations | Total     |
| Interest income                  | \$ 32,010                            | \$ -                                | \$ 48    | \$ (48 )                     | \$ 32,010 |
| Interest expense                 | 5,707                                | -                                   | 804      | (48 )                        | 6,463     |
| Noninterest income               | 3,714                                | 2,919                               | 24       | -                            | 6,657     |
| Income before income<br>taxes    | 9,956                                | 1,841                               | (2,162 ) | -                            | 9,635     |
| Net income                       | 7,557                                | 1,215                               | (1,853 ) | -                            | 6,919     |
| Depreciation and<br>amortization | 1,489                                | 15                                  | -        | -                            | 1,504     |
| Total assets                     | 1,304,236                            | -                                   | 903      | -                            | 1,305,139 |
| Capital expenditures             | 549                                  | -                                   | -        | -                            | 549       |



|                         | Nine Months Ended September 30, 2010 |            |          |              |           |
|-------------------------|--------------------------------------|------------|----------|--------------|-----------|
|                         | Community                            | Trust and  |          | Intersegment |           |
|                         | Banking                              | Investment | Other    | Eliminations | Total     |
|                         |                                      | Services   |          |              |           |
| Interest income         | \$ 27,044                            | \$ -       | \$ 103   | \$ (103 )    | \$ 27,044 |
| Interest expense        | 5,596                                | -          | 1,030    | (103 )       | 6,523     |
| Noninterest income      | 3,649                                | 2,528      | 31       | -            | 6,208     |
| Operating income before |                                      |            |          |              |           |
| income taxes            | 8,243                                | 1,659      | (1,083 ) | -            | 8,819     |
| Net income              | 6,047                                | 1,095      | (715 )   |              | 6,427     |
| Depreciation and        |                                      |            |          |              |           |
| amortization            | 1,211                                | 13         | -        | -            | 1,224     |
| Total assets            | 823,582                              | -          | 635      | -            | 824,217   |
| Capital expenditures    | 1,887                                | 1          | -        | -            | 1,888     |

## Index

### Note 14 – Fair Value of Financial Instruments

#### Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The recent fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

#### Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

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

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

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

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

**Securities available for sale:** Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using

pricing models that consider observable market data (Level 2). Federal Reserve Bank of Richmond and Federal Home Loan Bank stocks are carried at cost since no ready market exists and there is no quoted market value. The Company is required to own stock in these entities as long as it is a member. Therefore, they have been excluded from the table below.

Index

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2011 (in thousands):

| Description                          | Fair Value Measurements at September 30, 2011 Using |  |   |   |
|--------------------------------------|---|--|---|---|
|                                      | Balance as of September 30, 2011                    | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Assets:                              |   |  |   |   |
| Securities available for sale:       |   |  |   |   |
| Federal agencies and GSE             | \$ 34,253   | \$ -   | \$ 34,253                                   | \$ -                                    |
| Mortgage-backed & private label CMOs | 96,970  | -  | 96,970                                      | -                                       |
| State and municipal                  | 177,909   | -  | 177,909                                     | -                                       |
| Corporate                            | 2,385   | -  | 2,385                                       | -                                       |
| Total                                | \$ 311,517  | \$ -   | \$ 311,517                                  | \$ -                                    |

| Description                          | Fair Value Measurements at December 31, 2010 Using |  |   |   |
|--------------------------------------|--|--|---|---|
|                                      | Balance as of December 31, 2010                    | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Assets:                              |  |  |   |   |
| Securities available for sale:       |  |  |   |   |
| Federal agencies and GSE             | \$ 58,077  | \$ -   | \$ 58,077                                   | \$ -                                    |
| Mortgage-backed & private label CMOs | 62,982   | -  | 62,594                                      | 388                                     |
| State and municipal                  | 105,098  | -  | 105,098                                     | -                                       |
| Corporate                            | 2,138  | -  | 2,138                                       | -                                       |
| Total                                | \$ 228,295   | \$ -   | \$ 227,907                                  | \$ 388                                  |

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

|  | Total Realized / Unrealized Gains (Losses) Included in |            |                            |  |                              |                                   |
|--|--|------------|----------------------------|--|------------------------------|-----------------------------------|
|  | Balances as of January 1, 2011                         | Net Income | Other Comprehensive Income | Purchases, Sales, Issuances and Settlements, Net | Transfer In (Out) of Level 3 | Balances as of September 30, 2011 |
| Securities available for sale                          |  |            |                            |  |                              |                                   |
| Private label Collateralized Mortgage Obligation (ARM) | \$ 388   | \$ (46 )   | \$ 177                     | \$ (519 )  | \$ -                         | \$ -                              |
| Total assets   | \$ 388   | \$ (46 )   | \$ 177                     | \$ (519 )  | \$ -                         | \$ -                              |

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

Index

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

**Loans held for sale:** Loans held for sale are carried at estimated fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the period ended September 30, 2011. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

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

**Other real estate owned:** Certain assets such as other real estate owned ("OREO") are measured at fair value less cost to sell. OREO is measured at fair value using an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using market date (Level 2). However, if an appraisal of the real estate property is over two years old, then the fair value is considered to be Level 3. We believe that the fair value component in our valuation of OREO follows the provisions of accounting standards.

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

| Description                                   | Balance as of<br>September 30,<br>2011 | Fair Value Measurements at September 30, 2011<br>Using                         |   |  |
|---|--|--|---|--|
|   |  | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>Level 1 | Significant<br>Other<br>Observable<br>Inputs<br>Level 2 | Significant<br>Unobservable<br>Inputs<br>Level 3 |
| Assets  |  |  |   |  |
| Loans held for sale                           | \$ 3,359                               | -  | \$ 3,359  | -  |
| Impaired loans, net of<br>valuation allowance | 1,847                                  | -  | 1,847   | -  |

|                         |       |   |       |   |
|-------------------------|-------|---|-------|---|
| Other real estate owned | 5,920 | - | 5,920 | - |
|-------------------------|-------|---|-------|---|

| Description                                   | Fair Value Measurements at December 31, 2010 |   |  |   |
|---|--|---|--|---|
|   | Balance as of<br>December 31,<br>2010        | Using<br>Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>Level 1 | Using<br>Significant<br>Other<br>Observable<br>Inputs<br>Level 2 | Using<br>Significant<br>Unobservable<br>Inputs<br>Level 3 |
| Assets  |  |   |  |   |
| Loans held for sale                           | \$ 3,135                                     | -   | \$ 3,135   | -   |
| Impaired loans, net of<br>valuation allowance | 560  | -   | 560  | -   |
| Other real estate owned                       | 3,716  | -   | 3,716  | -   |

Index

The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments are as follows:

| (in thousands)                | September 30, 2011 |                      | December 31, 2010 |                      |
|-------------------------------|--------------------|----------------------|-------------------|----------------------|
|                               | Carrying Amount    | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Financial assets:             |                    |                      |                   |                      |
| Cash and due from banks       | \$ 53,536          | \$ 53,536            | \$ 18,514         | \$ 18,514            |
| Securities available for sale | 311,517            | 311,517              | 228,295           | 228,295              |
| Securities held to maturity   | 2,383              | 2,450                | 3,334             | 3,440                |
| Loans held for sale           | 3,359              | 3,359                | 3,135             | 3,135                |
| Loans, net of allowance       | 808,772            | 806,313              | 512,361           | 519,338              |
| Accrued interest receivable   | 4,327              | 4,327                | 3,704             | 3,704                |
| Financial liabilities:        |                    |                      |                   |                      |
| Deposits                      | \$ 1,064,477       | \$ 1,078,714         | \$ 640,098        | \$ 642,705           |
| Repurchase agreements         | 43,758             | 43,758               | 47,084            | 47,084               |
| Other borrowings              | 10,238             | 10,091               | 14,598            | 14,600               |
| Trust preferred capital notes | 27,190             | 27,169               | 20,619            | 20,531               |
| Accrued interest payable      | 824                | 824                  | 831               | 831                  |

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

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

Securities. Fair values are based on quoted market prices or dealer quotes.

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

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

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

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

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

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



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

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

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2011 and December 31, 2010, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

Index

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

## Note 15 – Supplemental Cash Flow Information

| (dollars in thousands)                                     | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2011                               | 2010      |
| <b>Supplemental Schedule of Cash and Cash Equivalents:</b> |                                    |           |
| Cash and due from banks                                    | \$ 23,450                          | \$ 10,860 |
| Interest-bearing deposits in other banks                   | 30,086                             | 16,338    |
|  | \$ 53,536                          | \$ 27,198 |
| <b>Supplemental Disclosure of Cash Flow Information:</b>   |                                    |           |
| <b>Cash paid for:</b>                                      |                                    |           |
| Interest on deposits and borrowed funds                    | \$ 6,470                           | \$ 6,572  |
| Income taxes   | 1,754                              | 2,488     |
| <b>Noncash investing and financing activities:</b>         |                                    |           |
| Transfer of loans to other real estate owned               | 685                                | 1,008     |
| Unrealized gain on securities available for sale           | 8,509                              | 3,114     |
| <b>Transactons related to bank acquisitions:</b>           |                                    |           |
| <b>Assets acquired:</b>                                    |                                    |           |
| Investment securities                                      | 51,442                             | -         |
| Loans held for sale  | 113                                | -         |
| Loans, net of unearned income                              | 327,112                            | -         |
| Premises and equipment, net                                | 6,861                              | -         |
| Deferred income taxes                                      | 15,626                             | -         |
| Core deposit intangible                                    | 6,556                              | -         |
| Other real estate owned                                    | 3,538                              | -         |
| Other assets   | 14,135                             | -         |
| <b>Liabilities assumed:</b>                                |                                    |           |
| Demand, MMDA, & savings deposits                           | 281,311                            | -         |
| Time deposits  | 138,937                            | -         |
| FHLB advances  | 9,858                              | -         |
| Other borrowings   | 6,546                              | -         |
| Other liabilities  | 3,838                              | -         |
| Issuance of preferred stock                                | 5,000                              | -         |
| Issuance of common stock                                   | 29,905                             | -         |

Index

Note 16 – Recent Accounting Pronouncements

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

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

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

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

The Securities Exchange Commission (“SEC”) issued Final Rule No. 33-9002, “Interactive Data to Improve Financial Reporting.” The rule requires companies to submit financial statements in extensible business reporting language (XBRL) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011. The Company complied with this Rule beginning with the filing of the June 30, 2011 Form 10-Q.

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

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

Index

In April 2011, the FASB issued ASU 2011-03, “Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements.” The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

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

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

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

In September 2011, the FASB issued ASU 2011-08, “Intangible – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment.” The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to

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

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2010 for previously announced accounting pronouncements.

Index

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 (the "Bank", and collectively with American National Bankshares Inc., 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;
  - The failure of assumptions underlying the allowance for loan losses; and
- The potential for negative financial or operational impact of the recent merger with MidCarolina Financial Corporation.

Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2011 presentation.

Critical Accounting Policies

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principals ("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, (2) goodwill impairment, and (3) acquired loans. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements in the Company's 2010 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: Financial Accounting Standards Board ("FASB") Topic 450-25 Contingencies - Recognition which requires that losses be accrued when they are probable of occurring and estimable and Financial Accounting Standards Board ("FASB") Topic 310-10 Receivables – Overall – Subsequent Measurement 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.



## Index

The Company's allowance for loan losses has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates. With regard to commercial loans, the formula allowance uses historical loss experience 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, economic conditions, and portfolio concentrations. In the formula allowance, the migrated historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. With regard to consumer loans, the allowance calculations are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. 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 use of these computed 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.

### Acquired Loans with Specific Credit-Related Deterioration

Acquired loans with specific credit deterioration are accounted for by the Company in accordance with FASB Accounting Standards Codification ("ASC") 310-30. Certain acquired loans, those for which specific credit-related deterioration, since origination, is identified, are recorded at fair value reflecting the present value of the amounts expected to be collected. Income recognition on these loans is based on a reasonable expectation about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretable yield.

### 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 the third quarter of 2011 indicated that goodwill is not impaired and is properly recorded in the financial statements. No events or circumstances since December 31, 2010 have occurred that would question the impairment of goodwill.

### 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 Securities and Exchange Commission ("SEC") filings through a link on the Investors Relations page of the Company's web site at [www.amnb.com](http://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 information on the

Company's website is not incorporated into this report or any other filing the Company makes 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](http://www.sec.gov).

Index

ACQUISITION OF MIDCAROLINA FINANCIAL CORPORATION

On July 1, 2011, American National Bankshares Inc. (“American National”) completed its merger with MidCarolina Financial Corporation (“MidCarolina”) pursuant to the Agreement and Plan of Reorganization, dated December 15, 2010, between American National and MidCarolina (the “merger agreement”). MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank. The transaction has expanded the Company’s footprint in North Carolina, adding eight branches in Alamance and Guilford Counties.

Pursuant to the terms of the merger agreement, as a result of the merger, the holders of shares of MidCarolina common stock received 0.33 shares of American National common stock for each share of MidCarolina common stock held immediately prior to the effective date of the merger. Each share of American National common stock outstanding immediately prior to the merger has continued to be outstanding after the merger. Each option to purchase a share of MidCarolina common stock outstanding immediately prior to the effective date of the merger was converted into an option to purchase shares of American National common stock, adjusted for the 0.33 exchange ratio. Additionally, the holders of shares of noncumulative perpetual Series A preferred stock of MidCarolina received one share of a newly authorized noncumulative perpetual Series A preferred stock of American National for each MidCarolina preferred share held immediately before the merger. The American National Series A preferred stock has terms, preferences, rights and limitations that are identical in all material respects to the MidCarolina Series A preferred stock.

American National issued 1,626,157 shares of additional common stock in connection with the MidCarolina merger. This represents 20.9% of the now outstanding shares of American National.

Management expects the acquisition will be accretive to earnings. Most of the material changes in balance sheet and income statement categories during this reporting period are directly related to the impact of the MidCarolina merger.

RESULTS OF OPERATIONS

Earnings Performance

Three months ended September 30, 2011 and 2010

For the quarter ended September 30, 2011, the Company reported net income of \$4,129,000 compared to \$2,228,000 for the comparable quarter in 2010. The \$1,901,000 or 85.3% increase in earnings was primarily due to:

- the July 1, 2011 merger with MidCarolina, which resulted in \$1,474,000 in fair value related net adjustments, which increased pretax earnings; and
- there were \$390,000 of merger related expenses, which negatively impacted earnings.

SUMMARY INCOME STATEMENT  
(Dollars in thousands)

| For the three months ended<br>September 30, | 2011 | 2010 | \$ Change | % Change |
|---|------|------|-----------|----------|
|---|------|------|-----------|----------|

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

|                           |           |          |          |       |   |
|---------------------------|-----------|----------|----------|-------|---|
| Interest income           | \$ 14,779 | \$ 8,982 | \$ 5,797 | 64.5  | % |
| Interest expense          | (2,436 )  | (2,223 ) | (213 )   | 9.6   | % |
| Net interest income       | 12,343    | 6,759    | 5,584    | 82.6  | % |
| Provision for loan losses | (525 )    | (435 )   | (90 )    | 20.7  | % |
| Noninterest income        | 2,698     | 2,241    | 457      | 20.4  | % |
| Noninterest expense       | (8,564 )  | (5,531 ) | (3,033 ) | 54.8  | % |
| Income tax expense        | (1,823 )  | (806 )   | (1,017 ) | 126.2 | % |
| Net income                | \$ 4,129  | \$ 2,228 | \$ 1,901 | 85.3  | % |

Index

Nine months ended September 30, 2011 and 2010

For the nine month period ended September 30, 2011, the Company reported net income of \$6,919,000 compared to \$6,427,000 for the comparable quarter in 2010. The \$492,000 or 7.7% increase in earnings was primarily due to:

- the July 1, 2011 merger with MidCarolina, which resulted in \$1,474,000 in fair value related net adjustments, which increased pretax earnings; and
- there were \$1,534,000 of merger related expenses during the period, which negatively impacted earnings.

SUMMARY INCOME STATEMENT  
(Dollars in thousands)

| For the nine months ended<br>September 30, | 2011      | 2010      | \$ Change | %<br>Change |
|--|-----------|-----------|-----------|-------------|
| Interest income                            | \$ 32,010 | \$ 27,044 | \$ 4,966  | 18.4 %      |
| Interest expense                           | (6,463 )  | (6,523 )  | 60        | -0.9 %      |
| Net interest income                        | 25,547    | 20,521    | 5,026     | 24.5 %      |
| Provision for loan losses                  | (1,198 )  | (1,005 )  | (193 )    | 19.2 %      |
| Noninterest income                         | 6,657     | 6,208     | 449       | 7.2 %       |
| Noninterest expense                        | (21,371 ) | (16,905 ) | (4,466 )  | 26.4 %      |
| Income tax expense                         | (2,716 )  | (2,392 )  | (324 )    | 13.5 %      |
| Net income                                 | \$ 6,919  | \$ 6,427  | \$ 492    | 7.7 %       |

### 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.

Three months ended September 30, 2011 and 2010

Net interest income on a taxable equivalent basis increased \$5,792,000 or 81.4%, for the third quarter of 2011 compared to the same quarter of 2010. Virtually all of this increase was related to the July 1, 2011 merger with MidCarolina. Approximately 80% of the increase was related to volume increases, the remainder was interest rate related, as detailed in the Rate/Volume Analysis following this section.

For the third quarter of 2011 and 2010, the Company's yield on earnings assets was 5.23% and 4.89%, respectively. The cost of interest-bearing liabilities was 0.99% compared to 1.43%. The interest rate spread was 4.24% compared to 3.46% for the comparable 2010 quarter. The net interest margin, on a fully taxable equivalent basis, was 4.41% compared to 3.74%. Yields on loans were positively impacted by fair value related accretion income and generally higher contractual interest rates on the MidCarolina portfolio. Rates on interest bearing liabilities were also positively impacted by merger related fair value adjustments, but to a much lesser degree than loans. Rates on long term borrowings, trust preferred securities, were very positively impacted by the third quarter conversion of the \$20 million American National liability from a fixed rate of 6.66% to 90-day LIBOR plus 135 basis points.

Index

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended September 30, 2011 and 2010. 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 September 30, 2011 and 2010

(in thousands, except rates)

|                                       | Average Balance |           | Interest<br>Income/Expense |        | Yield/Rate |       |
|---------------------------------------|-----------------|-----------|----------------------------|--------|------------|-------|
|                                       | 2011            | 2010      | 2011                       | 2010   | 2011       | 2010  |
| <b>Loans:</b>                         |                 |           |                            |        |            |       |
| Commercial                            | \$ 136,204      | \$ 76,618 | \$ 1,603                   | \$ 934 | 4.67%      | 4.84% |
| Real estate                           | 685,628         | 441,069   | 10,778                     | 5,968  | 6.29       | 5.41  |
| Consumer                              | 8,529           | 6,405     | 163                        | 126    | 7.58       | 7.80  |
| Total loans                           | 830,361         | 524,092   | 12,544                     | 7,028  | 6.04       | 5.36  |
| <b>Securities:</b>                    |                 |           |                            |        |            |       |
| Federal agencies                      | 32,448          | 60,079    | 186                        | 459    | 2.29       | 3.06  |
| Mortgage-backed &<br>CMOs             | 87,785          | 53,839    | 615                        | 493    | 2.80       | 3.66  |
| State and municipal                   | 168,134         | 94,419    | 1,896                      | 1,217  | 4.51       | 5.16  |
| Other                                 | 7,728           | 6,195     | 78                         | 55     | 4.04       | 3.55  |
| Total securities                      | 296,095         | 214,532   | 2,775                      | 2,224  | 3.75       | 4.15  |
| Deposits in other banks               | 45,526          | 24,118    | 28                         | 90     | 0.24       | 1.48  |
| Total interest-earning<br>assets      | 1,171,982       | 762,742   | 15,347                     | 9,342  | 5.23       | 4.89  |
| Non-earning assets                    | 134,814         | 73,291    |                            |        |            |       |
| Total assets                          | \$1,306,796     | \$836,033 |                            |        |            |       |
| <b>Deposits:</b>                      |                 |           |                            |        |            |       |
| Demand                                | \$ 171,744      | \$ 90,731 | 132                        | 16     | 0.30       | 0.07  |
| Money market                          | 208,962         | 70,011    | 232                        | 94     | 0.44       | 0.53  |
| Savings                               | 72,088          | 63,562    | 26                         | 22     | 0.14       | 0.14  |
| Time                                  | 444,079         | 305,887   | 1,689                      | 1,590  | 1.51       | 2.06  |
| Total deposits                        | 896,873         | 530,191   | 2,079                      | 1,722  | 0.92       | 1.29  |
| Customer repurchase<br>agreements     | 45,356          | 59,126    | 82                         | 93     | 0.72       | 0.62  |
| Other short-term borrowings           | 2               | 92        | 0                          | 0      | 0.75       | 0.43  |
| Long-term borrowings                  | 37,439          | 29,174    | 275                        | 408    | 2.94       | 5.59  |
| Total interest-bearing<br>liabilities | 979,670         | 618,583   | 2,436                      | 2,223  | 0.99       | 1.43  |

|   |             |             |
|---|-------------|-------------|
| Noninterest-bearing                     |             |             |
| demand deposits                         | 170,618     | 103,501     |
| Other liabilities                       | 7,475       | 4,064       |
| Shareholders' equity                    | 149,033     | 109,885     |
| Total liabilities and                   |             |             |
| shareholders'                           | \$1,306,796 | \$836,033   |
| equity                                  |             |             |
|   |             |             |
| Interest rate spread                    |             | 4.24% 3.46% |
| Net interest margin                     |             | 4.41% 3.74% |
|   |             |             |
| Net interest income (taxable equivalent | 12,911      | 7,119       |
| basis)                                  |             |             |
| Less: Taxable equivalent                | 568         | 360         |
| adjustment                              |             |             |
| Net interest income                     | \$12,343    | \$ 6,759    |



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

| Interest income                | Three Months Ended September 30<br>2011 vs. 2010 |                           |          |
|--------------------------------|--|---------------------------|----------|
|                                | Interest<br>Increase<br>(Decrease)               | Change<br>Attributable to |          |
|                                |  | Rate                      | Volume   |
| Loans:                         |  |                           |          |
| Commercial                     | \$ 669   | \$ (33 )                  | \$ 702   |
| Real Estate                    | 4,810  | 1,086                     | 3,724    |
| Consumer                       | 37   | (4 )                      | 41       |
| Total loans                    | 5,516  | 1,049                     | 4,467    |
| Securities:                    |  |                           |          |
| Federal agencies               | (273 )   | (96 )                     | (177 )   |
| Mortgage-backed                | 122  | (136 )                    | 258      |
| State and municipal            | 679  | (169 )                    | 848      |
| Other securities               | 23   | 8                         | 15       |
| Total securities               | 551  | (393 )                    | 944      |
| Deposits in other banks        | (62 )  | (108 )                    | 46       |
| Total interest income          | 6,005  | 548                       | 5,457    |
| Interest expense               |  |                           |          |
| Deposits:                      |  |                           |          |
| Demand                         | 116  | 92                        | 24       |
| Money market                   | 138  | (19 )                     | 157      |
| Savings                        | 4  | 1                         | 3        |
| Time                           | 99   | (498 )                    | 597      |
| Total deposits                 | 357  | (424 )                    | 781      |
| Customer repurchase agreements | (11 )  | 13                        | (24 )    |
| Other borrowings               | (133 )   | (227 )                    | 94       |
| Total interest expense         | 213  | (638 )                    | 851      |
| Net interest income            | \$ 5,792   | \$ 1,186                  | \$ 4,606 |

## Nine months ended September 30, 2011 and 2010

Net interest income on a taxable equivalent basis increased \$5,491,000 or 25.6%, for the nine months ended September 30, 2011 compared to the comparable period in 2010. Virtually all of this increase was related to the July 1, 2011 merger with MidCarolina. Approximately 90% of the increase was related to volume increases, the remainder was interest rate related, as detailed in the Rate/Volume Analysis following this section.

For the first nine months of 2011 and 2010, the Company's yield on earnings assets was 4.93% and 4.98%, respectively. The cost of interest bearing liabilities was 1.17% compared to 1.43%. The interest rate spread was 3.76% compared to 3.55%. The net interest margin, on a fully taxable equivalent basis, was 3.98% compared to 3.82%. Yields on loans were positively impacted in the 2011 period by fair value related accretion income and generally higher contractual interest rates on the MidCarolina portfolio. Rates on interest bearing liabilities were also positively

impacted by merger related fair value adjustments, but to a much lesser degree than loans. Rates on long term borrowings, trust preferred securities, were very positively impacted by the third quarter 2011 conversion of the \$20 million American National liability from a fixed rate of 6.66% to 90-day LIBOR plus 135 basis points.

Index

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the nine months ended September 30, 2011 and 2010. 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 Nine Months Ended September 30, 2011 and 2010

(in thousands, except rates)

|                                   | Average Balance |            | Interest<br>Income/Expense |          | Yield/Rate |        |
|-----------------------------------|-----------------|------------|----------------------------|----------|------------|--------|
|                                   | 2011            | 2010       | 2011                       | 2010     | 2011       | 2010   |
| <b>Loans:</b>                     |                 |            |                            |          |            |        |
| Commercial                        | \$ 98,121       | \$ 78,180  | \$ 3,392                   | \$ 2,826 | 4.62 %     | 4.83 % |
| Real estate                       | 516,165         | 438,736    | 22,093                     | 18,096   | 5.71       | 5.50   |
| Consumer                          | 7,574           | 6,553      | 419                        | 397      | 7.40       | 8.10   |
| Total loans                       | 621,860         | 523,469    | 25,904                     | 21,319   | 5.56       | 5.43   |
| <b>Securities:</b>                |                 |            |                            |          |            |        |
| Federal agencies                  | 37,197          | 63,929     | 765                        | 1,535    | 2.74       | 3.20   |
| Mortgage-backed &<br>CMO's        | 67,843          | 47,795     | 1,571                      | 1,473    | 3.09       | 4.11   |
| State and municipal               | 141,481         | 80,625     | 4,889                      | 3,223    | 4.61       | 5.33   |
| Other                             | 6,538           | 6,933      | 193                        | 185      | 3.94       | 3.56   |
| Total securities                  | 253,059         | 199,282    | 7,418                      | 6,416    | 3.91       | 4.29   |
| Deposits in other<br>banks        | 29,104          | 26,754     | 112                        | 268      | 0.51       | 1.34   |
| Total interest-earning<br>assets  | 904,023         | 749,505    | 33,434                     | 28,003   | 4.93       | 4.98   |
| Non-earning assets                | 95,196          | 72,356     |                            |          |            |        |
| Total assets                      | \$ 999,219      | \$ 821,861 |                            |          |            |        |
| <b>Deposits:</b>                  |                 |            |                            |          |            |        |
| Demand                            | \$ 122,497      | \$ 94,607  | 167                        | 58       | 0.18       | 0.08   |
| Money market                      | 111,801         | 77,691     | 382                        | 285      | 0.46       | 0.49   |
| Savings                           | 66,138          | 63,644     | 69                         | 66       | 0.14       | 0.14   |
| Time                              | 363,655         | 281,601    | 4,628                      | 4,595    | 1.70       | 2.18   |
| Total deposits                    | 664,091         | 517,543    | 5,246                      | 5,004    | 1.06       | 1.29   |
| Customer repurchase<br>agreements | 45,452          | 61,698     | 244                        | 297      | 0.72       | 0.64   |
| Other short-term<br>borrowings    | 45              | 31         | 0                          | 0        | 0.47       | 0.43   |

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

|  |            |            |           |           |        |        |
|--|------------|------------|-----------|-----------|--------|--------|
| Long-term borrowings                           | 28,820     | 29,211     | 973       | 1,222     | 4.50   | 5.58   |
| Total interest-bearing liabilities             | 738,408    | 608,483    | 6,463     | 6,523     | 1.17   | 1.43   |
| Noninterest-bearing demand deposits            | 133,008    | 100,965    |           |           |        |        |
| Other liabilities                              | 4,619      | 3,901      |           |           |        |        |
| Shareholders' equity                           | 123,184    | 108,512    |           |           |        |        |
| Total liabilities and shareholders' equity     | \$ 999,219 | \$ 821,861 |           |           |        |        |
| Interest rate spread                           |            |            |           |           | 3.76 % | 3.55 % |
| Net interest margin                            |            |            |           |           | 3.98 % | 3.82 % |
| Net interest income (taxable equivalent basis) |            |            | 26,971    | 21,480    |        |        |
| Less: Taxable equivalent adjustment            |            |            | 1,424     | 959       |        |        |
| Net interest income                            |            |            | \$ 25,547 | \$ 20,521 |        |        |

Index

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

| Interest income         | Nine Months Ended September 30<br>2011 vs. 2010 |                           |          |
|-------------------------|---|---------------------------|----------|
|                         | Interest<br>Increase<br>(Decrease)              | Change<br>Attributable to |          |
|                         |   | Rate                      | Volume   |
| Loans:                  |   |                           |          |
| Commercial              | \$ 566  | \$ (128 )                 | \$ 694   |
| Real Estate             | 3,997   | 704                       | 3,293    |
| Consumer                | 22  | (36 )                     | 58       |
| Total loans             | 4,585   | 540                       | 4,045    |
| Securities:             |   |                           |          |
| Federal agencies        | (770 )  | (197 )                    | (573 )   |
| Mortgage-backed         | 98  | (423 )                    | 521      |
| State and municipal     | 1,666   | (487 )                    | 2,153    |
| Other securities        | 8   | 19                        | (11 )    |
| Total securities        | 1,002   | (1,088 )                  | 2,090    |
| Deposits in other banks | (156 )  | (178 )                    | 22       |
| Total interest income   | 5,431   | (726 )                    | 6,157    |
| Interest expense        |   |                           |          |
| Deposits:               |   |                           |          |
| Demand                  | 109   | 88                        | 21       |
| Money market            | 97  | (21 )                     | 118      |
| Savings                 | 3   | -                         | 3        |
| Time                    | 33  | (1,138 )                  | 1,171    |
| Total deposits          | 242   | (1,071 )                  | 1,313    |
| Repurchase agreements   | (53 )   | 31                        | (84 )    |
| Other borrowings        | (249 )  | (233 )                    | (16 )    |
| Total interest expense  | (60 )   | (1,273 )                  | 1,213    |
| Net interest income     | \$ 5,491  | \$ 547                    | \$ 4,944 |

Index

Noninterest Income

All comparisons discussed below are between the third quarter of 2011 and the third quarter of 2010. The primary driver of changes between the two periods was the July 1, 2011 merger between American National and MidCarolina, unless otherwise noted.

Noninterest income increased to \$2,698,000 in 2011 from \$2,241,000, in 2010, a \$457,000 or 20.4% improvement.

Fees from the management of trusts, estates, and asset management accounts increased to \$921,000 in 2011 from \$842,000 in 2010, a \$79,000 or 9.4% increase. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large and potentially volatile impact on revenue. Most of the increase in this category was related to improvement in the equity markets.

Service charges on deposit accounts increased to \$575,000 in 2011 from \$478,000 in 2010, a \$97,000 or 20.3% increase.

Other fees and commissions increased to \$429,000 in 2011 from \$290,000 in 2010, an increase of \$139,000 or 47.9%.

Mortgage banking income decreased to \$374,000 in 2011 from \$428,000 in 2010, a decline of \$54,000 or 12.6%. This business category slowed with the overall slowdown in the real estate market.

Securities gains decreased to \$0 for 2011 from \$67,000 in 2010.

Noninterest income for the nine month period ended September 30, 2011 increased to \$6,657,000 compared to \$6,208,000 for the 2010 period, a \$449,000 or 7.2% increase.

Noninterest Expense

All comparisons discussed below are between the third quarter of 2011 and the third quarter of 2010. The primary driver of changes between the two periods was the July 1, 2011 merger between American National and MidCarolina, unless otherwise noted.

Noninterest expense was \$8,564,000 for 2011 compared to \$5,531,000 for 2010, a \$3,033,000 or 54.8% increase.

Salaries were \$3,676,000 for 2011 compared to \$2,596,000 for 2010, a \$1,080,000 or 41.6% increase.

Employee benefits were \$731,000 for 2011 compared to \$564,000 for 2010, a \$167,000 or 29.6% increase.

The Federal Deposit Insurance Corporation ("FDIC") insurance assessment was \$94,000 for 2011 compared to \$203,000 for 2010, a \$109,000 or 53.7% decrease. This change was driven by the estimated cumulative impact of the change from a deposit based to an asset based premium assessment by the FDIC. It is not indicative of future quarterly deposit insurance costs.

Merger related expense was \$390,000 for 2011. There were no comparable expenses in 2010.

Noninterest expense in the nine months ended September 30, 2011 was \$21,371,000 compared to \$16,905,000 for the same period in 2010, for an increase of \$4,466,000 or 26.4%. Of this increase, \$1,534,000 or 34.4% was directly associated with nonrecurring merger related expense.

#### Income Taxes

The effective tax rate for the third quarter of 2011 was 30.6% compared to 26.6% for the third quarter of 2010.

The effective tax rate for the nine months ended September 30, 2011 was 28.2% compared to 27.1% for the same period of 2010.

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.

## Index

### 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 expense, which tends 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. During the reported periods, inflation and interest rates have been low.

## CHANGES IN FINANCIAL POSITION

### BALANCE SHEET ANALYSIS

#### Securities

The securities portfolio generates income, plays a major role in the management of interest rate sensitivity, provides a source of liquidity, is used to meet collateral requirements for public deposits, and facilitates commercial customers' repurchase agreements. The portfolio consists primarily of high quality, investment-grade securities. Federal agency and U. S. government sponsored enterprises, mortgage-backed securities, and state and municipal securities comprise the majority of the portfolio.

The available for sale securities portfolio was \$311,517,000 at September 30, 2011 compared to \$228,295,000 at December 31, 2010, an \$83,222,000 or 36.5% increase.

The held to maturity securities portfolio decreased to \$2,383,000 at September 30, 2011 from \$3,334,000 at December 31, 2010, a \$951,000 or 28.5% decline. As a practical matter, any new security purchase is classified as available for sale.

At September 30, 2011, the available for sale portfolio had an estimated fair value of \$311,517,000 and an amortized cost of \$301,043,000, resulting in a net unrealized gain of \$10,074,000.

At the same date, the held to maturity portfolio had an estimated fair value of \$2,450,000 and an amortized cost of \$2,383,000, resulting in a net unrealized gain of \$67,000.

The current economic challenges on a local, regional and national level have resulted in a significant slowdown in business activity throughout 2010 and into 2011. The Company is cognizant of the historically low interest rate environment and has elected to maintain a defensive asset liability strategy of purchasing high quality taxable securities of relatively short duration and longer term tax exempt securities, whose market values are not as volatile in rising rate environments as similarly termed taxable investments.

#### Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans increased \$306,269,000 or 58.4% between third quarter of 2011 and the third quarter of 2010.

Loans were \$817,858,000 at September 30, 2011 compared to \$520,781,000 at December 31, 2010, a \$297,077,000 or 57% increase.



Loans held for sale totaled \$3,359,000 at September 30, 2011, and \$3,135,000 at December 31, 2010, a \$224,000 or 7.1% increase.

Management of the loan portfolio is organized around portfolio segments. Each segment is comprised of a various loan types that are reflective of operational and regulatory management and reporting requirements. The following table presents the Company's loan portfolio by segment as of September 30, 2011 and December 31, 2010.

Index

Allowance and Provision for Loan Losses

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

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

Risk grades are assigned as part of the origination process. From time to time risk grades may be modified as warranted by the facts and circumstances surrounding the credit.

Calculations of the allowance for loan losses are prepared quarterly by the Loan Review department. The Company's Credit Committee, Audit Committee, and Board of Directors review the allowance for adequacy. In determining the adequacy of the allowance, factors which are considered include, but are not limited to, historical loss experience, the size and composition of the loan portfolio, loan risk ratings, nonperforming loans, impaired loans, other problem credits, the value and adequacy of collateral and guarantors, and national, regional and local economic conditions and trends.

The Company's allowance for loan losses has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates. With regard to commercial loans, the formula allowance uses historical loss experience 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, economic conditions, and portfolio concentrations. In the formula allowance, the migrated historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. With regard to consumer loans, the allowance calculations for consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. 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 use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

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

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

to calculate the allowance and the size of the allowance in comparison to peer banks.

At September 30, 2011, the allowance for loan losses was \$9,086,000, compared to \$8,420,000 at December 31, 2010. The allowance for loan losses as a percentage of loans at each of those dates was 1.11% and 1.62%, respectively. The decrease in the allowance as a percentage of total loans is due solely to the acquisition of MidCarolina. On July 1, 2011, American National acquired loans with a fair value of \$327.1 million, net of a fair value adjustment of \$40.3 million. The acquired loans represented approximately 40% of total loans at the merger date.

The provision for loan losses for the nine-month period ended September 30, 2011 was \$1,198,000 and the provision for the 2010 comparable period was \$1,490,000.

Index

Net loans charge-offs totaled \$532,000 for the nine-month period ended September 30, 2011 compared to \$1,236,000 in the same period in 2010. Annualized net charge offs to average loans for the first nine months of 2011 totaled 0.09% and 0.24% for the comparable period in 2010.

The following table presents the Company's loan loss and recovery experience for the periods indicated.

| (in thousands)                    | Nine Months<br>September 30,<br>2011 | Year<br>December 31,<br>2010 |
|-----------------------------------|--------------------------------------|------------------------------|
| Balance at beginning of period    | \$ 8,420                             | \$ 8,166                     |
| Charge-offs:                      |                                      |                              |
| Construction and land development | 426                                  | -                            |
| Commercial real estate            | -                                    | 666                          |
| Residential real estate           | 280                                  | 310                          |
| Home equity                       | 50                                   | 135                          |
| Total real estate                 | 756                                  | 1,111                        |
| Commercial and industrial         | 132                                  | 306                          |
| Consumer                          | 69                                   | 114                          |
| Total charge-offs                 | 957                                  | 1,531                        |
| Recoveries:                       |                                      |                              |
| Construction and land development | -                                    | 147                          |
| Commercial real estate            | 10                                   | 9                            |
| Residential real estate           | 34                                   | 29                           |
| Home equity                       | 10                                   | 2                            |
| Total real estate                 | 54                                   | 187                          |
| Commercial and industrial         | 316                                  | 32                           |
| Consumer                          | 55                                   | 76                           |
| Total recoveries                  | 425                                  | 295                          |
| Net charge-offs                   | 532                                  | 1,236                        |
| Provision for loan losses         | 1,198                                | 1,490                        |
| Balance at end of period          | \$ 9,086                             | \$ 8,420                     |

## Asset Quality Indicators

The following table provides qualitative indicators relevant to the Company's loan portfolio.

## Asset Quality Ratios

|                     | September 30,<br>2011 |   | December 31,<br>2010 |   |
|---------------------|-----------------------|---|----------------------|---|
| Allowance to loans* | 1.11                  | % | 1.62                 | % |
|                     | 1.77                  |   | 1.62                 |   |

Allowance to loans (excluding acquired loans)\*

|  |        |        |
|--|--------|--------|
| Net charge-offs to year-end allowance# | 7.81   | 14.68  |
| Net charge-offs to average loans#      | 0.09   | 0.24   |
| Nonperforming assets to total assets*  | 1.48   | 0.76   |
| Nonperforming loans to loans*          | 1.65   | 0.50   |
| Provision to net charge-offs           | 225.19 | 120.52 |
| Provision to average loans#            | 0.26   | 0.29   |
| Allowance to nonperforming loans*      | 67.53  | 324.22 |

\* - at quarter or year-end

# - annualized

Index

## Nonperforming Assets (Loans and Other Real Estate Owned)

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 loans to total loans were 1.65% at September 30, 2011 compared to 0.50% at December 31, 2010.

Nonperforming assets include nonperforming loans and other real estate owned. Nonperforming assets represented 1.48% of total assets at September 30, 2011, up from 0.76% at December 31, 2010. Included in nonperforming assets, there were \$670,000 in troubled debt restructurings at September 30, 2011 and \$0 at December 31, 2010.

It is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The \$19,375,000 in nonperforming loans shown on the following table includes \$1,847,000 in impaired loans which were also on nonaccrual status. The remainders represent loans which were not deemed impaired. Based on the performance of these loans and existing circumstances, management did not believe loss was probable and did not classify these loans as impaired. Included in nonaccrual loans were \$670,000 of loans modified as troubled debt restructurings.

The following table presents the Company's nonperforming assets.

|                            | Nonperforming Assets<br>(in thousands) |                         |
|----------------------------|--|-------------------------|
|                            | September 30,<br>2011                  | December<br>31,<br>2010 |
| Nonaccrual loans:          |  |                         |
| Real estate                | \$ 11,555                              | \$ 2,181                |
| Commercial                 | 1,840                                  | 401                     |
| Agricultural               | -                                      | -                       |
| Consumer                   | 60                                     | 15                      |
| Total nonaccrual loans     | 13,455                                 | 2,597                   |
| Foreclosed real estate     | 5,920                                  | 3,716                   |
| Total nonperforming assets | \$ 19,375                              | \$ 6,313                |

## Impaired Loans

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

Impaired Loans  
(in thousands)

|                      | September<br>30,<br>2011 | December<br>31,<br>2010 |
|----------------------|--------------------------|-------------------------|
| Accruing             | \$ -                     | \$ -                    |
| Nonaccruing          | 1,847                    | 560                     |
| Total impaired loans | \$ 1,847                 | \$ 560                  |

Included in the impaired loan totals were \$670,000 in troubled debt restructured loans at September 30, 2011 and \$0 at December 31, 2010.

Index

## Other Real Estate Owned (Foreclosed Assets)

Other real estate owned was carried on the consolidated balance sheets at \$5,920,000 at September 30, 2011 and \$3,716,000 at December 31, 2010. Other real estate owned is initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the allowance for loan losses at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell. For significant amounts, these valuations are usually provided by outside annual appraisals.

The following table shows the Company's Other Real Estate Owned.

|                                     | Other Real Estate Owned<br>(in thousands) |                         |
|-------------------------------------|---|-------------------------|
|                                     | September<br>30,<br>2011                  | December<br>31,<br>2010 |
| Construction and land development   | \$ 3,315                                  | \$ 2,293                |
| Farmland                            | -   | -                       |
| 1-4 family residential              | 185                                       | 1,078                   |
| Multifamily (5 or more) residential | 1,053                                     | -                       |
| Commercial real estate              | 1,367                                     | 345                     |
|                                     | \$ 5,920                                  | \$ 3,716                |

## Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$1,064,477,000 at September 30, 2011 compared to \$640,098,000 at December 31, 2010, a \$424,379,000 or 66.3% increase.

Of total deposits, approximately \$63,445,000 are considered brokered time deposits. This represents 5.96% of total deposits. Management plans for these deposits to roll off upon maturity.

## Shareholders' Equity

The Company's capital management strategy is to be classified as "well capitalized" under regulatory capital ratios and provide as high as possible total return to our shareholders.

Shareholders' equity was \$151,361,000 at September 30, 2011 compared to \$108,087,000 at December 31, 2010, an increase of \$43,274,000 or 40%. Most of the increase was related to consideration paid in connection with the MidCarolina merger. The Company issued approximately 1.6 million common shares aggregating additional equity of \$29.9 million, and also issued \$5 million in preferred shares.



The Company paid cash dividends of \$0.23 per share during the third quarter of 2011 while the basic and diluted earnings per share for the same period were \$0.52. The Company paid cash dividends of \$0.69 per share for the first nine months of 2011 while the basic and diluted earnings per share were \$1.02.

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 combination 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.

Index

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 September 30, 2011, the Company's Tier I and total capital ratios were 14.32% and 15.36%, respectively. At December 31, 2010, these ratios were 18.38% and 19.64%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 10.16% and 12.74% at September 30, 2011 and December 31, 2010, 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 September 30, 2011, 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, and MidCarolina Statutory Trust I and II, acquired during the recent merger which issued trust preferred securities, the Company does not have any off-balance sheet subsidiaries. Off-balance sheet transactions were as follows (in thousands):

|                                     | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------------|-----------------------|----------------------|
| Commitments to extend credit        | \$ 201,496            | \$ 134,435           |
| Standby letters of credit           | 3,668                 | 1,588                |
| Mortgage loan rate-lock commitments | 5,198                 | 4,235                |

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.

Index

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 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 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. The simulation projects that if rates increase over a 12 month period by one percent, net interest income is expected to increase by 3.2%. Management has no expectation that market rates will decline in the near term, given the prevailing economy.

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 and the Federal Reserve Bank's discount window, federal funds lines of credit from three 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. At September 30, 2011, principal advance obligations to the FHLB consisted of \$10,375,000 in fixed-rate, long-term advances compared to \$8,488,000 in long-term advances and \$6,110,000 in short-term advances at December 31, 2010. The Company also had outstanding \$72,000,000 in letters of credit at September 30, 2011 and \$20,000,000 in letters of credit at December 31, 2010. The letters of credit provide the Bank with alternate collateral for securing public entity deposits above Federal Deposit Insurance Corporation insurance levels, thereby providing less need for collateral pledging from the securities portfolio.

Index

The Company had fixed-rate term advance borrowing contracts with the FHLB as of September 30, 2011, with the following final maturities:

| Amount    | Maturity Date |
|-----------|---------------|
| \$ 375    | March 2014    |
| 9,863     | November 2017 |
| \$ 10,238 |               |

The fixed rate term advance due November 2017 is net of a fair value adjustment of \$137,000.

The Company has federal funds lines of credit established with three correspondent banks in the amounts of \$15,000,000, \$12,000,000, and \$10,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at September 30, 2011.

There has been material changes to the Company's balance sheet as a result of the merger. However, in the opinion of management, there have been no material changes to market risk as disclosed in the Company's 2010 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 September 30, 2011. 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. On July 1, 2011, American National acquired MidCarolina. The Company expects that for the period between July 2011 and mid-February 2012, the Company will maintain MidCarolina Bank with its existing management information system, pending a software conversion in early 2012 for both the Bank and MidCarolina Bank. The Company currently merges general ledger activity for both the Bank's and MidCarolina Bank's information systems in order to prepare consolidated financial statements. This does constitute a significant change in the Company's internal controls over financial reporting during the quarter ended September 30, 2011, but, in the opinion of management, the controls over financial reporting remain effective.

Index

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.

The following risk factors are in addition to the risk factors disclosed in the Company's 2010

Annual Report on Form 10-K filed with the SEC on March 11, 2011:

Combining the Company and MidCarolina may be more difficult, costly or time-consuming than the Company expects.

Until the completion of the MidCarolina merger, the Company and MidCarolina operated independently. The integration process after the merger may result in the loss of key employees and inconsistencies in standards, controls, procedures and policies that affect adversely the Company's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the MidCarolina merger. As with any merger of financial institutions, there also may be disruptions that cause the Company to lose customers or cause customers to withdraw their deposits from the Bank or MidCarolina Bank, or other unintended consequences that could have a material adverse effect on the Company's results of operations or financial condition after the merger.

The Bank may not be able to effectively integrate the operations of MidCarolina Bank and the Bank.

The future operating performance of the Company and the Bank will depend, in part, on the success of the merger of MidCarolina Bank and the Bank. The success of the merger of the banks will, in turn, depend on a number of factors, including: the Company's ability to (i) integrate the operations and branches of MidCarolina Bank and the Bank; (ii) retain the deposits and customers of MidCarolina Bank and the Bank; (iii) control the incremental increase in noninterest expense arising from the merger in a manner that enables the combined bank to improve its overall operating efficiencies; and (iv) retain and integrate the appropriate personnel of MidCarolina Bank into the operations of the Bank, as well as reducing overlapping bank personnel. The integration of MidCarolina Bank and the Bank will require the dedication of the time and resources of the banks' management, and may temporarily distract managements' attention from the day-to-day business of the banks. If the Bank is unable to successfully integrate MidCarolina Bank, the Bank may not be able to realize expected operating efficiencies and eliminate redundant costs.

|   |    |   |
|---|----|---|
| None                                      | 2. | Unregistered Sales of Equity Securities and Use of Proceeds |
|   | 3. | Defaults Upon Senior Securities<br>None                     |
|   | 4. | (Removed and Reserved)                                      |
| (a) Required 8-K disclosures<br>None      | 5. | Other Information   |
| (b) Changes in Nominating Process<br>None |    |   |

50

---

Index

|         | 6.      | Exhibit No. | Exhibit Description   |
|---------|---------|-------------|---|
|         | 11.0    |             | 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 William W. Traynham, 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 William W. Traynham, Senior Vice President and Chief Financial Officer |
|         | 101.INS |             | XBRL Instance Document  |
| 101.SCH |         |             | XBRL Taxonomy Extension Schema Document   |
|         | 101.CAL |             | XBRL Taxonomy Extension Calculation Linkbase Document   |
|         | 101.DEF |             | XBRL Taxonomy Extension Definition Linkbase Document  |
|         | 101.LAB |             | XBRL Taxonomy Extension Label Linkbase Document   |
|         | 101.PRE |             | XBRL Taxonomy Presentation Linkbase Document  |

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 – November 8, 2011

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

Date – November 8, 2011

/s/ William W. Traynham  
William W. Traynham  
Senior Vice President and  
Chief Financial Officer



Index