

AMERICAN NATIONAL BANKSHARES INC  
Form 10-Q  
November 08, 2007

**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, 2007.**

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 7, 2007, the Company had 6,115,125 shares Common Stock outstanding, \$1 par value.

---

## AMERICAN NATIONAL BANKSHARES INC.

Index		Page
<b>Part I</b>	<b>FINANCIAL INFORMATION</b>	
Item 1	Financial Statements (Unaudited)	
	<u>Consolidated Balance Sheets</u> as of September 30, 2007 and December 31, 2006	3
	<u>Consolidated Statements of Income</u> for the three months ended September 30, 2007 and 2006	4
	<u>Consolidated Statements of Income</u> for the nine months ended September 30, 2007 and 2006	5
	<u>Consolidated Statements of Changes in Shareholders' Equity</u> for the nine months ended September 30, 2007 and 2006	6
	<u>Consolidated Statements of Cash Flows</u> for the nine months ended September 30, 2007 and 2006	7
	<u>Notes</u> to Consolidated Financial Statements	8
Item 2	<u>Management's Discussion and Analysis</u> of the Financial Condition and Results of Operations	14
Item 3	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	22
Item 4	<u>Controls and Procedures</u>	23
<b>Part II</b>	<b>OTHER INFORMATION</b>	
Item 1	<u>Legal Proceedings</u>	23
Item 1A	<u>Risk Factors</u>	23
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	23
Item 3	<u>Defaults Upon Senior Securities</u>	23
Item 4	<u>Submission of Matters to a Vote of Security Holders</u>	23
Item 5	<u>Other Information</u>	23
Item 6	<u>Exhibits</u>	23

SIGNATURES

24

2

---

Index

**American National Bankshares Inc. and Subsidiary**  
**Consolidated Balance Sheets**  
*(Dollars in thousands)*

	(Unaudited) September 30 2007	(Audited) December 31 2006
<b>ASSETS</b>		
Cash and due from banks	\$ 20,016	\$ 24,375
Interest bearing deposits in other banks	24	1,749
Securities available for sale, at fair value	136,270	148,748
Securities held to maturity (fair value of \$12,220 in 2007 and \$14,131 in 2006)	12,009	13,873
Total securities	148,279	162,621
Loans held for sale	375	1,662
Loans, net of unearned income	554,002	542,228
Less allowance for loan losses	(7,334)	(7,264)
Net loans	546,668	534,964
Bank premises and equipment, at cost, less accumulated depreciation of \$15,592 in 2007 and \$14,755 in 2006	13,197	12,438
Goodwill	22,468	22,468
Core deposit intangibles, net	2,546	2,829
Accrued interest receivable and other assets	13,981	14,614
Total assets	\$ 767,554	\$ 777,720
<b>LIABILITIES and SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Demand deposits -- noninterest bearing	\$ 105,014	\$ 106,885
Demand deposits -- interest bearing	105,004	107,170
Money market deposits	52,271	50,948
Savings deposits	63,565	69,517
Time deposits	260,300	274,008
Total deposits	586,154	608,528
Repurchase agreements	48,665	33,368
FHLB borrowings	8,975	15,087
Trust preferred capital notes	20,619	20,619
Accrued interest payable and other liabilities	3,807	5,126
Total liabilities	668,220	682,728

Shareholders' equity:		
Preferred stock, \$5 par, 200,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 10,000,000 shares authorized, 6,121,325 shares outstanding at September 30, 2007 and 6,161,865 shares outstanding at December 31, 2006	6,121	6,162
Capital in excess of par value	26,364	26,414
Retained earnings	68,188	64,584
Accumulated other comprehensive income (loss), net	(1,339)	(2,168)
Total shareholders' equity	99,334	94,992
Total liabilities and shareholders' equity	\$ 767,554	\$ 777,720

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

Index

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

	Three Months Ended September 30	
	2007	2006
<b>Interest Income:</b>		
Interest and fees on loans	\$ 10,506	\$ 10,210
Interest and dividends on securities:		
Taxable	1,060	1,314
Tax-exempt	416	432
Dividends	75	84
Other interest income	236	111
Total interest income	12,293	12,151
<b>Interest Expense:</b>		
Interest on deposits	4,004	3,699
Interest on repurchase agreements	478	376
Interest on trust preferred capital notes	343	344
Interest on other borrowings	122	226
Total interest expense	4,947	4,645
<b>Net Interest Income</b>	<b>7,346</b>	<b>7,506</b>
Provision for loan losses	-	125
<b>Net Interest Income After Provision for Loan Losses</b>	<b>7,346</b>	<b>7,381</b>
<b>Noninterest Income:</b>		
Trust fees	861	843
Service charges on deposit accounts	631	696
Mortgage banking income	240	172
Brokerage fees	191	93
Other fees and commissions	193	194
Securities gains, net	45	9
Other	115	131
Total noninterest income	2,276	2,138
<b>Noninterest Expense:</b>		
Salaries	2,380	2,355
Pension and other employee benefits	779	649
Occupancy and equipment	881	775
Bank franchise tax	165	171
Other	1,174	1,167
Total noninterest expense	5,379	5,117
Income Before Income Tax Provision	4,243	4,402
Income Tax Provision	1,309	1,301
<b>Net Income</b>	<b>\$ 2,934</b>	<b>\$ 3,101</b>
<b>Net Income Per Common Share:</b>		
Basic	\$ 0.48	\$ 0.50

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

Diluted	\$	0.48	\$	0.50
<b>Average Common Shares Outstanding:</b>				
Basic		6,132,288		6,165,268
Diluted		6,151,750		6,195,972

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



Index

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

	Nine Months Ended September 30	
	2007	2006
<b>Interest Income:</b>		
Interest and fees on loans	\$ 30,993	\$ 27,255
Interest and dividends on securities:		
Taxable	3,224	3,824
Tax-exempt	1,259	1,313
Dividends	246	219
Other interest income	575	534
Total interest income	36,297	33,145
<b>Interest Expense:</b>		
Interest on deposits	11,647	9,544
Interest on repurchase agreements	1,353	1,020
Interest on trust preferred capital notes	1,030	664
Interest on other borrowings	498	681
Total interest expense	14,528	11,909
<b>Net Interest Income</b>	<b>21,769</b>	<b>21,236</b>
Provision for loan losses	303	605
<b>Net Interest Income After Provision for Loan Losses</b>	<b>21,466</b>	<b>20,631</b>
<b>Noninterest Income:</b>		
Trust fees	2,664	2,483
Service charges on deposit accounts	1,878	2,004
Mortgage banking income	759	508
Brokerage fees	439	327
Other fees and commissions	591	561
Securities gains, net	134	47
Other	454	376
Total noninterest income	6,919	6,306
<b>Noninterest Expense:</b>		
Salaries	7,284	6,866
Pension and other employee benefits	2,164	1,971
Occupancy and equipment	2,560	2,165
Bank franchise tax	498	481
Other	3,491	3,373
Total noninterest expense	15,997	14,856
Income Before Income Tax Provision	12,388	12,081
Income Tax Provision	3,719	3,572
<b>Net Income</b>	<b>\$ 8,669</b>	<b>\$ 8,509</b>
<b>Net Income Per Common Share:</b>		
Basic	\$ 1.41	\$ 1.44

Diluted	\$	1.40	\$	1.43
<b>Average Common Shares Outstanding:</b>				
Basic		6,146,349		5,926,599
Diluted		6,171,243		5,960,556

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

Index

**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Changes in Shareholders' Equity**  
 Nine Months Ended September 30, 2007 and 2006  
 (Unaudited) (Dollars in thousands)

	Common Stock		Capital in Excess of Par Value	Retained Earnings	Accumulated	
	Shares	Amount			Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balance, December 31, 2005</b>	5,441,758	\$ 5,442	\$ 9,588	\$ 59,109	\$ (720)	\$ 73,419
Net income	-	-	-	8,509	-	8,509
Change in unrealized losses on securities available for sale, net of tax of \$ (53)	-	-	-	-	(65)	
Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$ (16)	-	-	-	-	(31)	
Other comprehensive income (loss)					(96)	(96)
Total comprehensive income						8,413
Merger acquisition	746,944	747	16,799			17,546
Stock repurchased and retired	(34,200)	(34)	(111)	(652)	-	(797)
Stock options exercised	11,548	11	150	-	-	161
Cash dividends declared (\$ .65 per share)	-	-	-	(3,854)	-	(3,854)
<b>Balance, September 30, 2006</b>	6,166,050	\$ 6,166	\$ 26,426	\$ 63,112	\$ (816)	\$ 94,888
	6,161,865	\$ 6,162	\$ 26,414	\$ 64,584	\$ (2,168)	94,992

<b>Balance, December 31, 2006</b>							
Net income	-	-	-	8,669	-	8,669	
Change in unrealized gains on securities available for sale, net of tax of \$ 494	-	-	-	-	916		
Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$ (47)	-	-	-	-	(87)		
Other comprehensive income (loss)					829	829	
Total comprehensive income						9,498	
Stock repurchased and retired	(53,200)	(53)	(228)	(887)	-	(1,168)	
Stock options exercised	12,660	12	178	-	-	190	
Cash dividends declared (\$ .68 per share)	-	-	-	(4,178)	-	(4,178)	
<b>Balance, September 30, 2007</b>	6,121,325	\$ 6,121	\$ 26,364	\$ 68,188	\$ (1,339)	\$ 99,334	

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

Index

**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
 Nine Months Ended September 30, 2007 and 2006  
 (Dollars in thousands) (Unaudited)

	2007	2006
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 8,669	\$ 8,509
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	303	605
Depreciation	855	709
Core deposit intangible amortization	283	307
Accretion of purchase accounting adjustments	-	(200)
Net (accretion) of bond premiums and discounts	(118)	(7)
Net gain on sale or call of securities	(134)	(47)
Gain on loans held for sale	(583)	(306)
Proceeds from sales of loans held for sale	28,202	12,264
Originations of loans held for sale	(26,332)	(12,402)
Net gain on foreclosed real estate	(6)	(10)
Change in valuation allowance for foreclosed real estate	-	9
Gain on sale of premises and equipment	(9)	-
Deferred income tax expense	52	19
Change in interest receivable	(257)	(904)
Change in other assets	924	(938)
Change in interest payable	(51)	337
Change in other liabilities	(1,268)	(1,452)
Net cash provided by operating activities	10,530	6,493
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sales of securities available for sale	1,061	460
Proceeds from maturities and calls of securities available for sale	39,934	43,828
Proceeds from maturities and calls of securities held to maturity	1,864	4,162
Purchases of securities available for sale	(26,989)	(44,531)
Net change in loans	(12,505)	3,676
Proceeds from sale of bank property and equipment	25	-
Purchases of bank property and equipment	(1,630)	(634)
Proceeds from sales of foreclosed real estate	30	212
Increase in foreclosed real estate	(59)	-
Net cash paid in merger acquisition	-	(14,634)
Net cash provided by (used in) investing activities	1,731	(7,461)
<b>Cash Flows from Financing Activities:</b>		
Net change in demand, money market, and savings deposits	(8,666)	(9,235)
Net change in time deposits	(13,708)	(21,134)

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

Net change in repurchase agreements	15,297	(51)
Net change in borrowings	(6,112)	33,381
Cash dividends paid	(4,178)	(3,854)
Repurchase of stock	(1,168)	(797)
Proceeds from exercise of stock options	190	161
Net cash used in financing activities	(18,345)	(1,529)
Net Decrease in Cash and Cash Equivalents	(6,084)	(2,497)
Cash and Cash Equivalents at Beginning of Period	26,124	27,354
Cash and Cash Equivalents at End of Period	\$ 20,040	\$ 24,857

Supplemental Schedule of Cash and Cash Equivalents:

Cash and due from banks	\$ 20,016	\$ 24,390
Interest bearing deposits in other banks	24	467
	\$ 20,040	\$ 24,857

Supplemental Disclosure of Cash Flow Information:

Interest paid	\$ 14,578	\$ 10,589
Income taxes paid	2,379	2,651
Transfer of loans to other real estate owned	498	115
Unrealized gain (loss) on securities available for sale	1,276	(165)

Merger acquisition		
Fair value of assets acquired	-	175,423
Fair value of common stock issued	-	(17,546)
Cash paid	-	(17,087)
Liabilities assumed	-	140,790

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

Index

**AMERICAN NATIONAL BANKSHARES INC. AND SUBSIDIARY  
NOTES TO FINANCIAL STATEMENTS**

***Note 1 – Basis of Presentation***

The consolidated financial statements include the amounts and results of operations of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the “Company”).

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, 2007; the consolidated statements of income for the three months and nine months ended September 30, 2007 and 2006; the consolidated statements of changes in shareholders’ equity for the nine months ended September 30, 2007 and 2006; and the consolidated statements of cash flows for the nine months ended September 30, 2007 and 2006. Operating results for the nine month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. Certain reclassifications have been made to prior period balances to conform to the current period presentation. The statements should be read in conjunction with the Notes to Financial Statements included in the Company’s Form 10-K for the year ended December 31, 2006.

***Note 2 - Securities***

The amortized cost and estimated fair value of investments in debt and equity securities at September 30, 2007 and December 31, 2006 were as follows:

(in thousands)	September 30, 2007			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Debt securities:				
Federal agencies	\$ 67,898	\$ 401	\$ 147	\$ 68,152
Mortgage-backed	27,034	215	173	27,076
State and municipal	34,569	152	336	34,385
Corporate	1,485	-	54	1,431
Equity securities:				
FHLB stock – restricted	1,851	-	-	1,851
Federal Reserve stock - restricted	1,429	-	-	1,429
FNMA and FHLMC preferred stock	1,716	136	-	1,852
Other	94	-	-	94
Total securities available for sale	136,076	904	710	136,270
Securities held to maturity:				
Mortgage-backed	328	8	-	336
State and municipal	11,681	224	21	11,884

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

Total securities held to maturity	12,009	232	21	12,220
Total securities	\$ 148,085	\$ 1,136	\$ 731	\$ 148,490
December 31, 2006				
(in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Debt securities:				
Federal agencies	\$ 88,106	\$ 40	\$ 819	\$ 87,327
Mortgage-backed	19,225	104	353	18,976
State and municipal	33,608	168	423	33,353
Corporate	2,490	3	56	2,437
Equity securities:				
FHLB stock - restricted	2,248	-	-	2,248
Federal Reserve stock - restricted	1,429	-	-	1,429
FNMA and FHLMC preferred stock	2,643	254	-	2,897
Other	81	-	-	81
Total securities available for sale	149,830	569	1,651	148,748
Securities held to maturity:				
Federal agencies	1,001	-	12	989
Mortgage-backed	385	9	-	394
State and municipal	12,487	291	30	12,748
Total securities held to maturity	13,873	300	42	14,131
Total securities	\$ 163,703	\$ 869	\$ 1,693	\$ 162,879



Index

The following table shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2007.

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies	\$ 29,826	\$ 147	\$ 4,994	\$ -	\$ 24,832	\$ 147
Mortgage-backed	8,206	173	60	1	8,146	172
State and municipal	25,827	357	1,581	8	24,246	349
Corporate	1,431	54	-	-	1,431	54
<b>Total</b>	<b>\$ 65,290</b>	<b>\$ 731</b>	<b>\$ 6,635</b>	<b>\$ 9</b>	<b>\$ 58,655</b>	<b>\$ 722</b>

Management evaluates securities for other-than-temporary impairment quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The unrealized losses are attributable to interest rate changes and not credit concerns of the issuer. The Company has the intent and ability to hold these securities for the time necessary to recover the amortized cost. As of September 30, 2007, the Company held 110 securities that had been in a continuous unrealized loss position for twelve months or more.

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, 2006.

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies	\$ 72,091	\$ 831	\$ 21,439	\$ 113	\$ 50,652	\$ 718
Mortgage-backed	11,091	353	242	2	10,849	351
State and municipal	25,310	453	3,784	51	21,526	402
Corporate	1,429	56	-	-	1,429	56
<b>Total</b>	<b>\$ 109,921</b>	<b>\$ 1,693</b>	<b>\$ 25,465</b>	<b>\$ 166</b>	<b>\$ 84,456</b>	<b>\$ 1,527</b>

**Note 3 - Loans**

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

(in thousands)	September 30, 2007	December 31, 2006
Construction and land development	\$ 69,476	\$ 69,404
Commercial real estate	205,048	186,639

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

Residential real estate	133,476	131,126
Home equity	46,671	52,531
Total real estate	454,671	439,700

Commercial and industrial	88,638	91,511
Consumer	10,693	11,017
Total loans	\$ 554,002	\$ 542,228

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

(in thousands)	September 30, 2007	December 31, 2006
Impaired loans without a valuation allowance	\$ 1,301	\$ 472
Impaired loans with a valuation allowance	1,754	904
Total impaired loans	\$ 3,055	\$ 1,376
Allowance provided for impaired loans, included in the allowance for loan losses	\$ 1,159	\$ 241
Nonaccrual loans excluded from the impaired loan disclosure	\$ 1,152	\$ 2,311

Index

(in thousands)	As of and for the Three Months Ended September 30 2007	As of and for the Nine Months Ended September 30 2007	As of and for the Three Months Ended September 30 2006	As of and for the Nine Months Ended September 30 2006
Average balance in impaired loans	\$ 3,821	\$ 2,566	\$ 1,896	\$ 2,871
Interest income recognized on impaired loans	\$ 64	\$ 171	\$ 5	\$ 36
Interest income recognized on nonaccrual loans	\$ -	\$ -	\$ -	\$ 49
Interest on nonaccrual loans had they been accruing	\$ 28	\$ 176	\$ -	\$ 251
Loans past due 90 days and still accruing interest	\$ 157	\$ 157	\$ 1,276	\$ 1,276

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

Foreclosed real estate was \$632,000 at September 30, 2007 and \$99,000 at December 31, 2006, and is included in other assets on the Consolidated Balance Sheets.

**Note 4 – 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, 2007 and 2006, and for the year ended December 31, 2006 are presented below:

(in thousands)	Nine Months Ended September 30, 2007	Year Ended December 31, 2006	Nine Months Ended September 30, 2006
<b>Allowance for Loan Losses</b>			
Balance, beginning of period	\$ 7,264	\$ 6,109	\$ 6,109
Allowance acquired in merger	-	1,598	1,598
Provision for loan losses	303	58	605
Charge-offs	(431)	(913)	(465)
Recoveries	198	412	323
Balance, end of period	\$ 7,334	\$ 7,264	\$ 8,170

**Reserve for unfunded  
lending commitments**

Balance, beginning of period	\$	128	-	\$	-
Provision for unfunded commitments		(20)	123		-
Balance, end of period	\$	108	\$	123	\$

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

**Note 5 – Goodwill and Other Intangible Assets**

In January 2002, the Company adopted Statement of Financial Accounting Standard (SFAS) 142, *Goodwill and Other Intangible Assets*. Accordingly, goodwill is no longer subject to amortization, but is subject to at least an annual assessment for impairment by applying a fair value-based test. A fair value-based test was performed during the third quarter of 2007 that determined the market value of the company shares exceeds the consolidated carrying value, including goodwill; therefore there has been no impairment recognized in the value of goodwill.

The changes in the carrying amount of goodwill for the quarter ended September 30, 2007, are as follows (in thousands):

Balance as of January 1, 2007	\$ 22,468
Goodwill recorded during the period	-
Impairment losses	-
Balance as of September 30, 2007	\$ 22,468

Core deposit intangibles resulting from the acquisition of Community First Financial Corporation on April 1, 2006 were \$3,112,000 and are being amortized over 99 months.

Index**Note 6– Trust Preferred Securities**

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “Trust”) and a newly formed, wholly owned subsidiary of the Company, issued \$20,000,000 of preferred securities (the “Trust 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 Trust Preferred Securities require quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate will reset quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to twenty consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

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

**Note 7 – Stock Based Compensation**

The Company maintained a stock option plan until its expiration on December 31, 2006, which provided for the granting of incentive and non-statutory options to employees on a periodic basis. The existing stock options are still covered by the plan although the plan expired at the end of 2006. The Company’s stock options had an exercise price equal to the fair value of the stock on the date of grant. Effective January 1, 2006, the Company adopted SFAS 123R, *Share Based Payment*, using the modified prospective method and as such, results for prior periods have not been restated. SFAS 123R requires public companies to recognize compensation expense related to stock based compensation awards, such as stock options and restricted stock, in their income statements over the period during which an employee is required to provide service in exchange for such award. SFAS 123R eliminated the choice to account for employee stock options under Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*.

Prior to the implementation of SFAS 123R, the Company applied APB 25 and related interpretations in accounting for stock options. Under APB 25, no stock based compensation expense was recorded, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. There have been no stock options granted since 2004 and all options were fully vested at December 31, 2004.

There were no tax benefits associated with stock option activity during the first nine months of 2007 or 2006. Under SFAS 123R, a company may only recognize tax benefits for stock options that ordinarily will result in a tax deduction when the option is exercised (“non-statutory” options). The Company has no non-statutory stock options.

Stock option plan activity for the nine months ended September 30, 2007 is summarized below:

Shares	Weighted Average Exercise Price	Average Remaining Contractual Life (in	Average Intrinsic Value
--------	--	---	-------------------------------

			years)	(in thousands)
Options outstanding, January 1	201,849	\$	20.36	
Granted	-		-	
Exercised	(12,660)		15.00	
Forfeited	(8,226)		14.00	
Outstanding at September 30	180,963	\$	21.02	4.5 \$ 481
Exercisable September 30	180,963		21.02	4.5 481

The total intrinsic value of options exercised during the three month and nine month periods ended September 30, 2007 was \$87,841 and \$195,991, respectively.

Index**Note 8 – Earnings Per Share**

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

	Three Months Ended September 30			
	2007		2006	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	6,132,288	\$ .48	6,165,268	\$ .50
Effect of dilutive securities (stock options)	19,462	-	30,704	-
Diluted earnings per share	6,151,750	\$ .48	6,195,972	\$ .50

	Nine Months Ended September 30			
	2007		2006	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	6,146,349	\$ 1.41	5,926,599	\$ 1.44
Effect of dilutive securities (stock options)	24,894	(.01)	33,957	(.01)
Diluted earnings per share	6,171,243	\$ 1.40	5,960,556	\$ 1.43

Stock options on common stock which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2007 and 2006 because their effects were antidilutive averaged 88,027 and 88,227, respectively.

**Note 9 – Defined Benefit Plan**

Components of Net Periodic Benefit Cost (in thousands)	Three Months Ended September 30				Nine Months Ended September 30			
	2007		2006		2007		2006	
Service cost	\$	164	\$	165	\$	492	\$	456
Interest cost		104		88		314		264
Expected return on plan assets		(141)		(130)		(424)		(391)
		-		(6)		(1)		(18)

Amortization of prior service cost					
Recognized net actuarial loss	37	52	113	158	
Net periodic benefit cost	\$ 164	\$ 169	\$ 494	\$ 469	

The Company does not expect to make a cash contribution to the plan during 2007.

**Note 10 – Segment and Related Information**

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

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

Trust and investment services include estate planning, trust account administration, and investment management. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services division receives fees for investment and administrative services. Fees are also received by this division for individual retirement accounts managed for the community banking segment.

Amounts shown in the “Other” column include activities of American National Bankshares Inc. and its subsidiary, AMNB Statutory Trust I, which issued \$20,000,000 of preferred securities in 2006. Refer to Note 6 for additional information on the preferred securities. The “Other” column also includes corporate items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to reportable segments. Intersegment eliminations primarily consist of American National Bankshares Inc.’s investment in American National Bank and Trust Company and related equity earnings.



Index

Segment information for the three month and nine month periods ended September 30, 2007 and 2006 is shown in the following table.

	<b>Three Months Ended September 30, 2007</b>				
	<b>Community</b>	<b>Trust and</b>		<b>Intersegment</b>	
	<b>Banking</b>	<b>Investment</b>	<b>Other</b>	<b>Eliminations</b>	<b>Total</b>
		<b>Services</b>			
Interest income	\$ 12,293	\$ -	\$ -	\$ -	\$ 12,293
Interest expense	4,604	-	343	-	4,947
Noninterest income	1,208	1,052	16	-	2,276
Operating income before income taxes	4,117	500	(374)	-	4,243
Depreciation and amortization	379	6	1	-	386
Total assets	766,786	-	768	-	767,554
Capital expenditures	614	-	-	-	614

	<b>Three Months Ended September 30, 2006</b>				
	<b>Community</b>	<b>Trust and</b>		<b>Intersegment</b>	
	<b>Banking</b>	<b>Investment</b>	<b>Other</b>	<b>Eliminations</b>	<b>Total</b>
		<b>Services</b>			
Interest income	\$ 12,151	\$ -	\$ -	\$ -	\$ 12,151
Interest expense	4,645	-	-	-	4,645
Noninterest income	1,151	938	49	-	2,138
Operating income before income taxes	4,287	494	(379)	-	4,402
Depreciation and amortization	386	5	1	-	392
Total assets	791,882	-	752	-	792,634
Capital expenditures	229	-	-	-	229

	<b>Nine Months Ended September 30, 2007</b>				
	<b>Community</b>	<b>Trust and</b>		<b>Intersegment</b>	
	<b>Banking</b>	<b>Investment</b>	<b>Other</b>	<b>Eliminations</b>	<b>Total</b>
		<b>Services</b>			
Interest income	\$ 36,297	\$ -	\$ -	\$ -	\$ 36,297
Interest expense	13,498	-	1,030	-	14,528
Noninterest income	3,745	3,103	71	-	6,919
Operating income before income taxes	11,868	1,671	(1,151)	-	12,388
Depreciation and amortization	1,119	17	2	-	1,138
Total assets	766,786	-	768	-	767,554
Capital expenditures	1,614	16	-	-	1,630

**Nine Months Ended September 30, 2006**

	<b>Trust and</b>		<b>Intersegment</b>		
	<b>Community</b>	<b>Investment</b>		<b>Eliminations</b>	<b>Total</b>
	<b>Banking</b>	<b>Services</b>	<b>Other</b>		
Interest income	\$ 33,145	\$ -	\$ -	\$ -	\$ 33,145
Interest expense	11,909	-	-	-	11,909
Noninterest income	3,459	2,810	37	-	6,306
Operating income before income taxes	11,443	1,429	(791)	-	12,081
Depreciation and amortization	998	16	2	-	1,016
Total assets	791,882	-	752	-	792,634
Capital expenditures	633	1	-	-	634

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.

This report contains forward-looking statements with respect to the financial condition, results of operations and business of 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. Factors that may cause actual results to differ materially from those expected include the following:

- 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 such things as deterioration in credit quality, reduced demand for credit, and reductions in depositors' account balances.
  - Changes in interest rates could increase or reduce income.
- 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.
  - Adverse changes may occur in the securities markets.

**Reclassification**

In certain circumstances, reclassifications have been made to prior period information to conform to the 2007 presentation.

**Critical Accounting Policies**

The Company's critical accounting policies are listed below. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements in the Company's 2006 Annual Report on Form 10-K.

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within the 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 and reserve is based on two basic principles of accounting: (i) Statement of Financial Accounting Standards ("SFAS") 5, *Accounting for Contingencies*, which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS 114, *Accounting by Creditors for Impairment of a Loan*, which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows, or values observable in the secondary market, and the loan balance.

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

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

#### *Goodwill and Other Intangible Assets*

The Company adopted SFAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value-based test. Additionally, under SFAS 142, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Branch acquisition transactions were outside the scope of SFAS 142 and, accordingly, intangible assets related to such transactions continued to amortize upon the adoption of SFAS 142. The costs of purchased deposit relationships and other intangible assets, based on independent valuation by a qualified third party, are being amortized over their estimated lives. Core deposit intangible amortization expense charged to operations was \$94,000 for the third quarter of 2007 and \$134,000 for the same period of 2006, and \$283,000 and \$307,000 for the nine months ended September 30, 2007 and 2006, respectively.

Index

**Non-GAAP Presentations**

The Management's Discussion and Analysis may refer to the efficiency ratio, which is computed by dividing noninterest expense by the sum of net interest income on a taxable equivalent basis and noninterest income (excluding gains on sales of securities or other assets). This is a non-GAAP financial measure which management believes provides investors with important information regarding the Company's operational efficiency. Comparison of the Company's efficiency ratio with those of other companies may not be valid because other companies may calculate the efficiency ratio differently.

The analysis of net interest income in this document is performed on a taxable equivalent basis. Management believes the taxable equivalent presentation better reflects total return, as many financial assets have specific tax advantages that modify their effective yields. A reconciliation of taxable equivalent net interest income to net interest income is provided.

**New Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS 157. The Company has not yet adopted this standard and does not expect the implementation of SFAS 159 to have a material impact on its consolidated financial statements.

Refer to the Company's December 31, 2006 Annual Report on Form 10-K for previously announced accounting pronouncements.

**Internet Access to Corporate Documents**

The Company provides access to its SEC filings through a link on the Investors Relations page of the Company's web site at [www.amnb.com](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 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).

## EXECUTIVE OVERVIEW

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

American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-three ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking. Additional information is available on the Company’s website at [www.amnb.com](http://www.amnb.com). The shares of American National Bankshares Inc. are traded on the NASDAQ Global Select Market under the symbol “AMNB.”

The Company specializes in providing financial services to businesses and consumers. Current priorities are to:

- continue to operate a highly profitable company
- increase the size of the loan portfolio without sacrificing credit quality or pricing,
- grow checking, savings and money market deposits,
- increase fee income, and
- continue to control costs.

Index

**ANALYSIS OF OPERATING RESULTS**

**Net Interest Income**

Net interest income, the Company's largest source of revenue, is the excess of interest income over interest expense. Net interest income is influenced by a number of factors, including the volume and mix of interest earning assets and interest bearing liabilities, interest rates earned on earning assets, and interest rates paid on deposits and borrowed funds. For analytical purposes, net interest income is adjusted to a taxable equivalent basis to recognize the income tax savings on tax-exempt assets, such as state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent ("FTE") basis. Net interest income divided by average earning assets is referred to as the net interest margin. The difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities is referred to as the net interest spread.

In comparison to the third quarter of 2006, net interest income on a taxable equivalent basis decreased \$200,000, or 2.6% in the third quarter of 2007 due primarily to an increase in rates paid on deposits and repurchase agreements, which caused interest expense to rise. For the nine months ended September 30, 2007, net interest income increased \$488,000 or 2.2% as compared to the first nine months of 2006. Average interest earning assets increased \$6,926,000, or 1.0% for the first nine months of 2007 in comparison to the same period in 2006 due largely to the acquisition of Community First Financial Corporation in April 2006. The positive effect of this increase in earning assets was somewhat offset by the impact of paying higher rates on deposits and repurchase agreements. The Company's net interest margin, on a fully taxable equivalent basis, was 4.27% during the third quarter of 2007, compared to 4.26% during the same quarter of 2006. The net interest margin was 4.22% for the nine months ended September 30, 2007, compared to 4.17% for the same period in 2006.

Index

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the third quarter 2007 and 2006. 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, 2007 and 2006

(in thousands, except yields and rates)

(Unaudited)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2007	2006	2007	2006	2007	2006
<b>Loans:</b>						
Commercial	\$ 89,531	\$ 86,944	\$ 1,774	\$ 1,715	7.93%	7.89%
Real estate	449,172	445,943	8,496	8,221	7.57	7.37
Consumer	10,702	13,104	253	297	9.46	9.07
Total loans	549,405	545,991	10,523	10,233	7.66	7.50
<b>Securities:</b>						
Federal agencies	64,738	96,205	732	990	4.52	4.12
Mortgage-backed	24,489	21,426	304	252	4.97	4.70
State and municipal	45,414	46,749	624	667	5.50	5.71
Other	6,655	10,670	97	160	5.83	6.00
Total securities	141,296	175,050	1,757	2,069	4.97	4.73
Deposits in other banks	18,093	8,510	236	112	5.22	5.26
Total interest earning assets	708,794	729,551	12,516	12,414	7.06	6.81
Nonearning assets	63,266	66,895				
Total assets	\$ 772,060	\$ 796,446				
<b>Deposits:</b>						
Demand	\$ 107,259	\$ 109,868	405	445	1.51	1.62
Money market	54,203	49,211	379	321	2.80	2.61
Savings	65,162	77,597	220	267	1.35	1.38
Time	260,803	272,807	3,000	2,666	4.60	3.91
Total deposits	487,427	509,483	4,004	3,699	3.29	2.90
Repurchase agreements	48,427	42,670	478	376	3.95	3.52
Other borrowings	29,932	38,114	465	570	6.21	5.98
Total interest bearing liabilities	565,786	590,267	4,947	4,645	3.50	3.15
Noninterest bearing demand deposits	103,477	107,064				



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

Other liabilities	4,870	5,468		
Shareholders' equity	97,927	93,647		
Total liabilities and shareholders' equity	\$ 772,060	\$ 796,446		
Interest rate spread			3.56%	3.66%
Net interest margin			4.27%	4.26%
Net interest income (taxable equivalent basis)		7,569	7,769	
Less: Taxable equivalent adjustment		223	263	
Net interest income		\$ 7,346	\$ 7,506	

Index**Net Interest Income Analysis**

For the Nine Months Ended September 30, 2007 and 2006

(in thousands, except yields and rates)

(Unaudited)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2007	2006	2007	2006	2007	2006
<b>Loans:</b>						
Commercial	\$ 90,117	\$ 86,946	\$ 5,286	\$ 4,749	7.82%	7.28%
Real estate	447,366	410,231	25,025	21,696	7.46	7.05
Consumer	10,495	12,689	742	871	9.43	9.15
Total loans	547,978	509,866	31,053	27,316	7.56	7.14
<b>Securities:</b>						
Federal agencies	71,931	97,630	2,337	2,832	4.33	3.87
Mortgage-backed	21,680	21,614	792	742	4.87	4.58
State and municipal	45,664	47,160	1,886	1,980	5.51	5.60
Other	7,794	11,523	342	473	5.85	5.47
Total securities	147,069	177,927	5,357	6,027	4.86	4.52
Deposits in other banks	14,760	15,088	575	535	5.19	4.73
Total interest earning assets	709,807	702,881	36,985	33,878	6.95	6.43
Nonearning assets	63,977	52,420				
Total assets	\$ 773,784	\$ 755,301				
<b>Deposits:</b>						
Demand	\$ 109,469	\$ 107,051	1,245	1,148	1.52	1.43
Money market	52,881	47,361	1,084	834	2.73	2.35
Savings	67,255	79,874	685	712	1.36	1.19
Time	259,891	252,420	8,633	6,850	4.43	3.62
Total deposits	489,496	486,706	11,647	9,544	3.17	2.61
Repurchase agreements	46,912	41,683	1,353	1,020	3.85	3.26
Other borrowings	33,487	31,476	1,528	1,345	6.08	5.70
Total interest bearing liabilities	569,895	559,865	14,528	11,909	3.40	2.84
Noninterest bearing demand deposits	101,949	102,177				
Other liabilities	4,979	3,728				
Shareholders' equity	96,961	89,531				
Total liabilities and shareholders' equity	\$ 773,784	\$ 755,301				

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

Interest rate spread	3.55%	3.59%
Net interest margin	4.22%	4.17%
Net interest income (taxable equivalent basis)		
	22,457	21,969
Less: Taxable equivalent adjustment		
	688	733
Net interest income	\$ 21,769	\$ 21,236

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

The Credit Committee has responsibility for determining the level and adequacy of the allowance for loan losses. Among other factors, the Committee, on a quarterly basis, considers the Company's historical loss experience; the size and composition of the loan portfolio; individual risk ratings; nonperforming loans; impaired loans; other problem credits; the value and adequacy of collateral and guarantors; and national and local economic conditions. The Audit and Compliance Committee and the Board of Directors also review the allowance calculation quarterly.

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

The allowance is supplemented to adjust for imprecision (particularly in commercial, commercial real estate and construction lending) and to provide for a range of possible outcomes inherent in estimates used for the allocated allowance. This reflects the result of management's judgment of risks inherent in the portfolio, economic uncertainties and other qualitative factors, including economic trends in the Company's regions.

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 Southside Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the local textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans.

The allowance is subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance in comparison to peer banks.

The provision for loan losses decreased from \$125,000 in the third quarter of 2006 to \$0 in the third quarter of 2007, and decreased from \$605,000 during the first nine months of 2006 to \$303,000 for the first nine months of 2007.

The allowance for loan losses was \$7,334,000 at September 30, 2007, an increase of 1.0% over the \$7,264,000 recorded at December 31, 2006. The allowance represented 1.32% of loans at September 30, 2007, in comparison to 1.34% at December 31, 2006. Management believes the allowance for loan losses is adequate to absorb losses inherent in the Company's loan portfolio at September 30, 2007. The decrease in the provision for loan losses allowed management to maintain directional consistency of the allowance with the improvement in the performance of the loan portfolio. More information regarding loan quality is provided in the "Asset Quality, Credit Risk Management, and Nonperforming Assets" section.

### **Noninterest Income**

Noninterest income rose 6.5% from \$2,138,000 in the third quarter of 2006 to \$2,276,000 in the third quarter of 2007. Noninterest income increased \$613,000, or 9.7% for the nine months ended September 30, 2007, as compared to the first nine months of 2006. The quarter and year-to-date increase was due in large part to growth in trust fees, mortgage banking revenue, brokerage fees, and gains on securities. The year-to-date increase was also due to a \$32,000 increase in income recognized from the cash value of bank owned life insurance and an increase in check charges of \$15,000 as compared to the same period in 2006.

Fees from the management of trusts, estates, and asset management accounts totaled \$861,000 in the third quarter of 2007, up 2.1% from \$843,000 for the same period in 2006. Trust fee income on a year-to-date basis increased \$181,000, or 7.3%, when compared to the same period in 2006. These increases were due primarily to new account activity and to fee schedule adjustments made in early 2007.

Mortgage banking income represents fees from originating, selling, and brokering residential mortgage loans. Mortgage banking income was \$240,000 for the third quarter of 2007, an increase of 39.5% from the third quarter of 2006. Mortgage banking income increased \$251,000, or 49.4% for the nine months ended September 30, 2007 as compared to the same period in 2006. Both quarter and year-to-date increase was due to an increase in volume.

Brokerage fees represent income earned from the sale of investment products. Brokerage fees were \$191,000 for the third quarter of 2007, an increase of 105.4% from the third quarter in 2006. Brokerage fees increased \$112,000, or 34.3% on a year-to-date basis in comparison to the same period in 2006. The quarterly and year-to-date increase was due to an increase in volume.

Gains on securities totaled \$45,000 in the third quarter of 2007, compared with \$9,000 in the third quarter of 2006. Gains on securities for the first nine months of 2007 were \$134,000, as compared to \$47,000 during the same period in 2006.

Index

**Noninterest Expense**

Noninterest expense increased \$262,000, or 5.1%, from the third quarter of 2006 to the same period in 2007. For the nine months ended September 30, 2007, noninterest expense increased \$1,141,000 or 7.7%.

Salary expense increased \$25,000 or 1.1% in the third quarter of 2007 as compared to the same period in 2006, while employee benefit expense increased 20% or \$130,000 over the same period. Personnel expense associated with a new branch office located at Smith Mountain Lake, Virginia and higher health insurance claims was partially offset with reductions in profit sharing and incentive plan expense. Salary expense increased \$418,000 or 6.1% for the nine months ended September 30, 2007 as compared to the same period of 2006. Employee benefit expense increased \$193,000 or 9.7% over the same period. This increase was largely attributable to the new Smith Mountain Lake office, increased health insurance claims, and additional personnel acquired with Community First Bank in April 2006.

Occupancy and equipment expense increased \$106,000 in the third quarter of 2007 as compared to the same period in 2006. This increase is primarily due to depreciation expense on new technology and other capital purchases and the costs associated with new branch offices opened at Smith Mountain Lake, and Bedford, Virginia. Occupancy and equipment expense increased \$395,000 for the nine months ended September 30, 2007 as compared to the same period of 2006. This increase can be attributed to the four branches acquired from Community First in addition to the expenses for the Smith Mountain Lake and Bedford offices.

Bank franchise tax expense decreased \$6,000 during the third quarter of 2007 in comparison to the same period of 2006, but increased \$17,000 on a year-to-date basis when compared to the same period in 2006. The increase is due primarily to the acquisition of Community First in April 2006.

Other noninterest expense increased \$7,000 in the third quarter of 2007 in comparison to the same quarter of 2006, and increased \$118,000 for the first nine months of 2007 in comparison to the first nine months of 2006, due primarily to the additional branches acquired from Community First and the Smith Mountain Lake office. Expenses for advertising and public relations, ATM and Visa network fees, Internet banking fees, professional services, automobile, courier service, recruiting and hiring, and tuition and training were categories that reflected increases for the nine month period.

**Income Tax Provision**

The effective tax rate for the third quarter of 2007 was 30.9% compared to 29.55% for the same period of 2006. The effective tax rate is lower than the statutory rate primarily due to the effect of the Company's ownership of tax-exempt securities and loans.

**FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL**

**Securities**

Average securities decreased \$33,754,000, or 19.3% during the third quarter of 2007, as compared to the same period in 2006. Maturing investments were used to pay-down borrowings and to fund reductions in high-rate certificates of deposit acquired from Community First in 2006 and decreases in other deposits.

**Loans**

Average loans were \$549,405,000 during the third quarter of 2007, compared with \$545,991,000 in the third quarter of 2006, a 0.6% increase. Average loans increased \$38,112,000, or 7.5% for the nine months ended September 30, 2007 from the same period in 2006, due in large part to the acquisition of Community First in 2006.

**Asset Quality, Credit Risk Management, and Nonperforming Assets**

Management identifies specific credit risks through its periodic analysis of the loan portfolio and monitors general risks arising from economic trends, market values, and other external factors. The Company maintains an allowance for loan losses, which is available to absorb losses inherent in the loan portfolio. The adequacy of the allowance for loan losses is determined on a quarterly basis. Various factors as defined in the section "Allowance and Provision for Loan Losses" are considered in determining the adequacy of the allowance.

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

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented 0.47% of total loans at September 30, 2007, and 0.63% at December 31, 2006.

Index

The following table summarizes nonperforming assets:

(in thousands)	September 30, 2007	December 31, 2006
Loans 90 days or more past due	\$ 157	\$ -
Nonaccrual loans	2,454	3,425
Nonperforming loans	2,611	3,425
Foreclosed real estate	632	99
Nonperforming assets	\$ 3,243	\$ 3,524

There were no troubled debt restructurings at September 30, 2007 or December 31, 2006.

**Liquidity and FHLB Borrowings**

Liquidity is the measure of the Company's ability to generate sufficient funds to meet cash needs such as customer demands for loans and the withdrawal of deposit balances. Liquidity sources include cash and amounts due from banks, deposits in other banks, loan repayments, increases in deposits, lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB") and two correspondent banks, and maturities and sales of securities. Management believes that these sources provide sufficient and timely liquidity.

Management monitors and forecasts the liquidity position for future periods. Liquidity strategies are implemented and monitored by an Asset/Liability Investment Committee. The Committee uses a simulation and budget model to manage the future liquidity needs of the Company.

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. Borrowings under the line were \$8,975,000 at September 30, 2007. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB.

The Company had fixed-rate term borrowing contracts with the FHLB as of September 30, 2007, with the following final maturities:

Amount (in thousands)	Expiration Date
\$ 3,000	June 2008
5,000	April 2009
975	March 2014
\$ 8,975	

The Company also has federal funds lines of credit established with two other banks in the amounts of \$15,000,000 and \$5,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at September 30, 2007.

**Deposits**



Average deposits were \$590,904,000 during the third quarter of 2007, down 4.2% from \$616,547,000 during the same quarter of 2006. The Company has allowed high-rate certificates of deposit issued by Community First to mature. Additionally, savings and demand deposits declined due primarily to intense competition for bank deposits.

**Off-Balance-Sheet Activities**

The Company enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance-sheet transactions. Other than AMNB Statutory Trust I, formed in 2006 to issue Trust Preferred Securities, the Company does not have any off-balance-sheet subsidiaries. Refer to Note 6 for discussion of AMNB Statutory Trust I. Off-balance-sheet transactions were as follows (in thousands):

	September 30, 2007	December 31, 2006
Commitments to extend credit	\$ 146,747	\$ 155,038
Standby letters of credit	7,183	3,125
Mortgage loan rate-lock commitments	1,823	2,246

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

**Shareholders' Equity**

One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Average shareholders' equity was 12.68% of average assets at September 30, 2007 and 11.76% at September 30, 2006. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios for financial institutions. 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, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At September 30, 2007, the Company's Tier I and total capital ratios were 16.79% and 18.05%, respectively. At December 31, 2006, these ratios were 16.18% and 17.45%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratios were 12.81% and 12.15% at September 30, 2007 and December 31, 2006, 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, 2007, that the Company met the requirements to be considered "well capitalized."

**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 other expenses that tend to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Company has the ability to react to those changes and measure and monitor its interest rate and liquidity risk.

**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 adverse changes in interest rates and market prices. The Company is generally not subject to currency exchange risk or commodity price risk.

As a financial institution, interest rate risk and its impact on net interest income is the primary market risk exposure. The magnitude of the change in earnings resulting from interest rate changes is impacted by the time remaining to maturity on fixed-rate obligations, the contractual ability to adjust rates prior to maturity, competition, and the general level of interest rates.

The Company's Asset/Liability Investment Committee ("ALCO") is primarily responsible for establishing asset and liability strategies and for monitoring and controlling liquidity and interest rate risk within established policy guidelines. ALCO is also responsible for evaluating the competitive interest rate environment and reviewing investment securities transactions.

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 maturities and payments 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, the model projects net interest income under multiple interest rate scenarios.

Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Also, the methodology uses estimates of various rates of withdrawal for money market deposits, savings, and checking accounts, which may vary significantly from actual experience. The Company is subject to prepayment risk, particularly in falling interest rate environments or in environments where the slope of the yield curve is relatively flat or negative. Such changes in the interest rate environment can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Company's interest rate sensitivity position. Additionally, credit risk may increase if an interest rate increase adversely affects the ability of borrowers to service their debt.

There have been no material changes to market risk as disclosed in the Company's 2006 Annual Report on Form 10-K. Refer to those disclosures for further information.

Index**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, 2007. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended September 30, 2007 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting. PART II

**OTHER INFORMATION**

Item:

## 1. Legal Proceedings

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

## 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the Company's 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2007.

## 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Repurchases made for the Quarter Ended September 30, 2007

Dates	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet Be Purchased Under the Program
July 1-31	2,500	\$ 22.49	2,500	93,300
August 1-15	18,500	20.96	18,500	74,800
August 16-31	4,100	21.36	4,100	120,900
September 1-30	3,800	21.26	3,800	117,100

On August 21, 2007, the Company's board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 125,000 shares of the Company's common stock between August 22, 2007 and August 19, 2008. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Company.

## 3. Defaults Upon Senior Securities

None

## 4. Submission of Matters to a Vote of Security Holders

None

5. Other Information

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

6. Exhibits

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

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

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

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

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

23

---

Index

**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, 2007

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

Date – November 8, 2007

/s/ Neal A. Petrovich  
Neal A. Petrovich  
Senior Vice President and  
Chief Financial Officer

Index