

AMERICAN NATIONAL BANKSHARES INC  
Form 10-Q  
November 08, 2010

---

---

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, 2010.

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,

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

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 4, 2010, the Company had 6,126,374 shares of Common Stock outstanding, \$1 par value.

---

## AMERICAN NATIONAL BANKSHARES INC.

<u>Index</u>		Page
Part I.	FINANCIAL INFORMATION	
Item 1	Financial Statements	
	<u>Consolidated Balance Sheets as of September 30, 2010 and December 31, 2009</u>	3
	<u>Consolidated Statements of Income for the three and nine months ended September 30, 2010 and 2009</u>	4-5
	<u>Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2010 and 2009</u>	6
	<u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2010 and 2009</u>	7
	<u>Notes to Consolidated Financial Statements</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	37
Item 4.	<u>Controls and Procedures</u>	38
Part II.	<u>OTHER INFORMATION</u>	
Item 1.	Legal Proceedings	39
Item 1A.	Risk Factors	39
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	39
Item 3.	Defaults Upon Senior Securities	39
Item 4.	(Removed and Reserved)	39

Item 5.	Other Information	39
Item 6.	Exhibits	39

SIGNATURES

Index

## Part I. Financial Information

## Item 1. Financial Statements

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

	(Unaudited) September 30, 2010	(Audited) December 31, 2009
<b>ASSETS</b>		
Cash and due from banks	\$ 10,860	\$ 13,250
Interest-bearing deposits in other banks	16,338	10,693
Securities available for sale, at fair value	209,434	188,795
Securities held to maturity (fair value of \$4,675 at September 30, 2010 and \$6,763 at December 31, 2009)	4,501	6,529
Total securities	213,935	195,324
Restricted stock, at cost	4,161	4,362
Loans held for sale	3,952	2,490
Loans, net of unearned income	519,421	527,991
Less allowance for loan losses	(8,542 )	(8,166 )
Net loans	510,879	519,825
Premises and equipment, net	20,142	19,195
Other real estate owned, net	3,987	3,414
Goodwill	22,468	22,468
Core deposit intangibles, net	1,415	1,698
Accrued interest receivable and other assets	16,080	16,254
Total assets	\$ 824,217	\$ 808,973
<b>LIABILITIES and SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Demand deposits -- noninterest bearing	\$ 101,578	\$ 101,735
Demand deposits -- interest bearing	91,301	97,025
Money market deposits	53,388	75,554
Savings deposits	62,841	61,873
Time deposits	316,522	268,086
Total deposits	625,630	604,273
Customer repurchase agreements	54,285	65,929
Long-term borrowings	8,525	8,638
Trust preferred capital notes	20,619	20,619

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

Accrued interest payable and other liabilities	4,290	3,125
Total liabilities	713,349	702,584
Shareholders' equity:		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 20,000,000 shares authorized, 6,126,374 shares outstanding at September 30, 2010 and 6,110,335 shares outstanding at December 31, 2009	6,126	6,110
Capital in excess of par value	27,200	26,962
Retained earnings	74,409	72,208
Accumulated other comprehensive income, net	3,133	1,109
Total shareholders' equity	110,868	106,389
Total liabilities and shareholders' equity	\$ 824,217	\$ 808,973

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 per share and per share data) (Unaudited)

	Three Months Ended September 30	
	2010	2009
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 6,994	\$ 7,666
Interest and dividends on securities:		
Taxable	1,253	1,241
Tax-exempt	621	434
Dividends	24	27
Other interest income	90	96
<b>Total interest and dividend income</b>	<b>8,982</b>	<b>9,464</b>
<b>Interest Expense:</b>		
Interest on deposits	1,722	1,921
Interest on short-term borrowings	93	135
Interest on long-term borrowings	65	65
Interest on trust preferred capital notes	343	343
<b>Total interest expense</b>	<b>2,223</b>	<b>2,464</b>
<b>Net Interest Income</b>	<b>6,759</b>	<b>7,000</b>
<b>Provision for Loan Losses</b>	<b>435</b>	<b>492</b>
<b>Net Interest Income After Provision for Loan Losses</b>	<b>6,324</b>	<b>6,508</b>
<b>Noninterest Income:</b>		
Trust fees	842	813
Service charges on deposit accounts	478	536
Other fees and commissions	290	257
Mortgage banking income	428	361
Securities gains, net	67	1
Foreclosed real estate gains, net	5	-
Other	136	151
<b>Total noninterest income</b>	<b>2,246</b>	<b>2,119</b>
<b>Noninterest Expense:</b>		
Salaries	2,596	2,471
Employee benefits	564	806
Occupancy and equipment	732	701
FDIC assessment	203	203
Bank franchise tax	168	160
	94	94

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

Core deposit intangible amortization		
Other	1,179	1,163
Total noninterest expense	5,536	5,598
Income Before Income Taxes	3,034	3,029
Income Taxes	806	862
Net Income	\$ 2,228	\$ 2,167
Net Income Per Common Share:		
Basic	\$ 0.36	\$ 0.36
Diluted	\$ 0.36	\$ 0.35
Average Common Shares Outstanding:		
Basic	6,125,359	6,104,505
Diluted	6,131,129	6,111,913

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 per share and per share data) (Unaudited)

	Nine Months Ended September 30	
	2010	2009
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 21,220	\$ 23,617
<b>Interest and dividends on securities:</b>		
Taxable	3,844	3,594
Tax-exempt	1,641	1,236
Dividends	71	70
Other interest income	268	287
<b>Total interest and dividend income</b>	<b>27,044</b>	<b>28,804</b>
<b>Interest Expense:</b>		
Interest on deposits	5,004	6,628
Interest on short-term borrowings	297	548
Interest on long-term borrowings	192	276
Interest on trust preferred capital notes	1,030	1,030
<b>Total interest expense</b>	<b>6,523</b>	<b>8,482</b>
<b>Net Interest Income</b>	<b>20,521</b>	<b>20,322</b>
<b>Provision for Loan Losses</b>	<b>1,005</b>	<b>1,334</b>
<b>Net Interest Income After Provision for Loan Losses</b>	<b>19,516</b>	<b>18,988</b>
<b>Noninterest Income:</b>		
Trust fees	2,455	2,338
Service charges on deposit accounts	1,440	1,549
Other fees and commissions	856	750
Mortgage banking income	1,017	1,215
Securities gains, net	42	2
Foreclosed real estate (losses), net	(279 )	(1,222 )
Other	398	474
<b>Total noninterest income</b>	<b>5,929</b>	<b>5,106</b>
<b>Noninterest Expense:</b>		
Salaries	7,590	7,734
Employee benefits	1,837	2,451
Occupancy and equipment	2,209	2,165
FDIC assessment	597	984
Bank franchise tax	503	483
Core deposit intangible amortization	283	283

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

Other	3,607	3,694
Total noninterest expense	16,626	17,794
Income Before Income Taxes	8,819	6,300
Income Taxes	2,392	1,659
Net Income	\$ 6,427	\$ 4,641
Net Income Per Common Share:		
Basic	\$ 1.05	\$ 0.76
Diluted	\$ 1.05	\$ 0.76
Average Common Shares		
Outstanding:		
Basic	6,122,876	6,094,261
Diluted	6,128,481	6,098,221

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, 2010 and 2009  
(Dollars in thousands) (Unaudited)

	Common Stock		Capital in	Retained	Accumulated	Total
	Shares	Amount	Excess of		Other	
			Par Value	Earnings	Comprehensive Income (Loss)	Equity
Balance, December 31, 2008	6,085,628	\$ 6,086	\$ 26,491	\$ 71,090	\$ (1,367 )	\$ 102,300
Net income	-	-	-	4,641	-	4,641
Change in unrealized gains on securities available for sale, net of tax, \$979	-	-	-	-	1,822	
Less: Reclassification adjustment for gains on securities available for sale, net of tax, \$0	-	-	-	-	(2 )	
Other comprehensive income					1,820	1,820
Total comprehensive income						6,461
Stock repurchased and retired	(7,600 )	(8 )	(33 )	(80 )	-	(121 )
Stock options exercised	29,299	29	395	-	-	424
Stock option expense	-	-	47	-	-	47
Cash dividends declared, \$0.69 per share	-	-	-	(4,206 )	-	(4,206 )
Balance, September 30, 2009	6,107,327	\$ 6,107	\$ 26,900	\$ 71,445	\$ 453	\$ 104,905
Balance, December 31, 2009	6,110,335	\$ 6,110	\$ 26,962	\$ 72,208	\$ 1,109	\$ 106,389

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

Net income	-	-	-	6,427	-	6,427
Change in unrealized gains on securities available for sale, net of tax, \$1,105	-	-	-	-	2,051	
Add: Reclassification adjustment for losses on impairment of securities, net of tax, \$11	-	-	-	-	20	
Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$(26)	-	-	-	-	(47 )	
Other comprehensive income					2,024	2,024
Total comprehensive income						8,451
Stock options exercised	2,855	3	44	-	-	47
Stock option expense	-	-	47	-	-	47
Equity based compensation	13,184	13	147	-	-	160
Cash dividends declared, \$0.69 per share	-	-	-	(4,226 )	-	(4,226 )
Balance, September 30, 2010	6,126,374	\$ 6,126	\$ 27,200	\$ 74,409	\$ 3,133	\$ 110,868

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, 2010 and 2009  
(Dollars in thousands) (Unaudited)

	2010	2009
Cash Flows from Operating Activities:		
Net income	\$ 6,427	\$ 4,641
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	1,005	1,334
Depreciation	941	877
Core deposit intangible amortization	283	283
Net amortization (accretion) of bond premiums and discounts	296	(180 )
Net gain on sale or call of securities	(73 )	(2 )
Impairment of securities	31	-
Gain on loans held for sale	(902 )	(1,074 )
Proceeds from sales of loans held for sale	36,195	53,564
Originations of loans held for sale	(36,755 )	(54,566 )
Net gain on foreclosed real estate	(2 )	(17 )
Net change in valuation allowance on foreclosed real estate	281	1,239
Stock-based compensation expense	47	47
Equity based compensation	160	-
Deferred income tax benefit	(311 )	(727 )
Net change in interest receivable	(451 )	(496 )
Net change in other assets	624	945
Net change in interest payable	(45 )	(318 )
Net change in other liabilities	432	1,082
Net cash provided by operating activities	8,183	6,632
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	815	-
Proceeds from sales of securities held to maturity	184	-
Proceeds from maturities and calls of securities available for sale	88,858	55,248
Proceeds from maturities and calls of securities held to maturity	1,299	583
Purchases of securities available for sale	(106,706 )	(100,525 )
Net decrease in loans	6,933	29,238
Purchases of bank property and equipment	(1,888 )	(3,138 )
Proceeds from sales of foreclosed real estate	156	317
Net cash used in investing activities	(10,349 )	(18,277 )

Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	(27,079 )	2,882
Net change in time deposits	48,436	4,275
Net change in repurchase agreements	(11,644 )	19,598
Net change in short-term borrowings	-	(3,850 )
Net change in long-term borrowings	(113 )	(5,112 )
Cash dividends paid	(4,226 )	(4,206 )
Repurchase of stock	-	(121 )
Proceeds from exercise of stock options	47	424
Net cash provided by financing activities	5,421	13,890
Net Increase in Cash and Cash Equivalents	3,255	2,245
Cash and Cash Equivalents at Beginning of Period	23,943	24,098
Cash and Cash Equivalents at End of Period	\$ 27,198	\$ 26,343

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 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. Refer to Note 9 for further details concerning this variable interest entity.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the Trust, as detailed in Note 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, 2010; the consolidated statements of income for the three and nine months ended September 30, 2010 and 2009; the consolidated statements of changes in shareholders’ equity for the nine months ended September 30, 2010 and 2009; and the consolidated statements of cash flows for the nine months ended September 30, 2010 and 2009. Operating results for the three and nine month periods ended September 30, 2010 are not necessarily indicative of the results that may occur for the year ending December 31, 2010. 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, 2009.

Note 2 – Recent Accounting Pronouncements

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, “Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140”, was adopted into Codification in December 2009 through the issuance of Accounting Standards Update (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. ASU 2009-16 was effective for transfers on or after January 1, 2010. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

In June 2009, the FASB issued new guidance relating to variable interest entities. The new guidance, which was issued as SFAS No. 167, "Amendments to FASB Interpretation No. 46(R)," was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 was effective as of January 1, 2010. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.



Index

In October 2009, the FASB issued ASU 2009-15, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing." ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, Accounting for Various Topics – Technical Corrections to SEC Paragraphs. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the FASB issued 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 February 2010, the FASB issued ASU 2010-09, "Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements." ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC's reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. 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, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become 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 rollforward and modification disclosures, will be required for periods beginning or after December 15, 2010. The Company is currently assessing the impact that ASU 2010-20 will have on its consolidated financial statements.

On September 15, 2010, the SEC issued Release No. 33-9142, "Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers." This release issued a final rule adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (SOX), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act. SOX Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934. Release No. 33-9142 was effective September 21, 2010.

Index

On September 17, 2010, the SEC issued Release No. 33-9144, "Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis." This interpretive release is intended to improve discussion of liquidity and capital resources in Management's Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant. This release was issued in conjunction with a proposed rule, "Short-Term Borrowings Disclosures," that would require public companies to disclose additional information to investors about their short-term borrowing arrangements. Release No. 33-9144 was effective on September 28, 2010.

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for previously announced accounting pronouncements.

## Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at September 30, 2010 and December 31, 2009 were as follows:

(in thousands)	Amortized Cost	September 30, 2010		Estimated Fair Value
		Unrealized Gains	Unrealized Losses	
Securities available for sale:				
Federal agencies & GSE	\$ 48,480	\$ 1,170	\$ -	\$ 49,650
Mortgage-backed & CMO's	56,474	1,664	379	57,759
State and municipal	95,241	4,637	11	99,867
Corporate	1,970	188	-	2,158
Total securities available for sale	202,165	7,659	390	209,434
Securities held to maturity:				
State and municipal	4,501	174	-	4,675
Total securities held to maturity	4,501	174	-	4,675
Total securities	\$ 206,666	\$ 7,833	\$ 390	\$ 214,109
(in thousands)	Amortized Cost	December 31, 2009		Estimated Fair Value
		Unrealized Gains	Unrealized Losses	
Securities available for sale:				
Federal agencies & GSE	\$ 81,279	\$ 1,474	\$ 7	\$ 82,746
Mortgage-backed & CMO's	41,365	1,535	310	42,590
State and municipal	58,035	1,442	181	59,296
Corporate	3,962	201	-	4,163
Total securities available for sale	184,641	4,652	498	188,795
Securities held to maturity:				
Mortgage-backed & CMO's	199	14	-	213
State and municipal	6,330	220	-	6,550
Total securities held to maturity	6,529	234	-	6,763
Total securities	\$ 191,170	\$ 4,886	\$ 498	\$ 195,558



Index

## 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, 2010. 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, at September 30, 2010, are as follows:

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Mortgage-backed	\$ 18,088	\$ 159	\$ 18,088	\$ 159	\$ -	\$ -
CMO's	2,057	220	767	3	1,290	217
State and municipal	1,813	11	1,813	11	-	-
Total	\$ 21,958	\$ 390	\$ 20,668	\$ 173	\$ 1,290	\$ 217

GSE residential mortgage-backed securities. The unrealized losses on the Company's investment in nine GSE mortgage-backed securities and one collateralized mortgage obligation ("CMO") were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency or GSE of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis 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, 2010.

Private-Label Residential Mortgage-Backed Securities: The unrealized losses associated with four private residential collateralized mortgage obligations are 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. Based upon our assessment of the expected credit losses of the security given the performance of the underlying collateral compared to our credit enhancement, we expect to recover the remaining amortized cost basis of three of these four securities. See Other than Temporarily Impaired Securities in the following section regarding one of these issues.

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, 2010.

The Company's investment in restricted stock of \$4,161,000 at September 30, 2010, shown as a separate line item on the consolidated balance sheets, includes \$2,610,000 in stock of the Federal Home Loan Bank of Atlanta ("FHLB"). FHLB stock is generally viewed as a long-term and restricted investment security, carried at cost, because there is no market for the stock, other than the FHLB 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 FHLB did temporarily suspend dividends and repurchases of excess capital stock in 2009. However, they have recently resumed both activities on a limited basis. The Company does not consider this investment to be other-than-temporarily impaired at September 30, 2010 and no impairment has been recognized.

Index

## Other than Temporarily Impaired Securities

One variable rate CMO was downgraded below investment grade to CCC status by Standard and Poor's during the first quarter 2010. Based upon a review of the security by an independent advisory firm, the Company elected to recognize an impairment charge to earnings of \$31,000 in the first quarter. The impairment charge was based on a review of recent actual historical performance and an estimate of expected annual ongoing losses of 0.91% and loss on loans sixty days or greater of 6.41%. The Other Comprehensive Income ("OCI") adjustment was based on an estimated 15% fair value return based on current market conditions. The investment was reviewed again for other than temporarily impairment ("OTTI") in the second and third quarter. No additional impairment was deemed necessary.

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, 2009.

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
GSE debt securities	\$ 28,918	\$ 7	\$ 28,918	\$ 7	\$ -	\$ -
Mortgage-backed CMO's	7,294	95	7,294	95	-	-
State and municipal	2,151	215	-	-	2,151	215
Total	\$ 45,783	\$ 498	\$ 43,203	\$ 247	\$ 2,580	\$ 251

## Note 4 - Loans

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

(in thousands)	September 30, 2010	December 31, 2009
Construction and land development	\$ 42,602	\$ 40,371
Commercial real estate	206,142	208,066
Residential real estate	118,554	121,639
Home equity	64,847	64,678
Total real estate	432,145	434,754
Commercial and industrial	80,818	86,312
Consumer	6,458	6,925
Total loans	\$ 519,421	\$ 527,991

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

(in thousands)	September 30, 2010	December 31, 2009
Impaired loans with a valuation allowance	\$ -	\$ 1,284
Impaired loans without a valuation allowance	1,766	2,540

Total impaired loans	\$ 1,766	\$ 3,824
----------------------	----------	----------

Index

	September 30, 2010	December 31, 2009
(in thousands)		
Allowance provided for impaired loans, included in the allowance for loan losses	\$ -	\$ 796
Nonaccrual loans excluded from the impaired loan disclosure	\$ 2,144	\$ 1,885
	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
(in thousands)		
Average balance in impaired loans	\$ 2,928	\$ 3,409
Interest income recognized on impaired loans	-	100
Interest income recognized on nonaccrual loans	-	-
Interest on nonaccrual loans had they been accruing	196	148
Loans past due 90 days and still accruing interest	-	-

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

Foreclosed real estate was \$3,987,000 at September 30, 2010 and \$3,414,000 December 31, 2009.

#### 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, 2010 and 2009, and for the year ended December 31, 2009, are presented below:

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009	Nine Months Ended September 30, 2009
(in thousands)			
Allowance for Loan Losses			
Balance, beginning of period	\$ 8,166	\$ 7,824	\$ 7,824
Provision for loan losses	1,005	1,662	1,334
Charge-offs	(869 )	(1,601 )	(1,116 )
Recoveries	240	281	218
Balance, end of period	\$ 8,542	\$ 8,166	\$ 8,260
Reserve for unfunded lending commitments			



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

Balance, beginning of period	\$ 260	475	\$ 475
Provision for unfunded commitments	(30 )	-	(11 )
Charge-offs	-	(215 )	(215 )
Balance, end of period	\$ 230	\$ 260	\$ 249

The reserve for unfunded loan commitments is included on the consolidated balance sheet in other liabilities.

Index

## Note 6 – Goodwill and Other Intangible Assets

In January 2002, the Company adopted SFAS 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 as of June 30, 2010 that determined there has been no impairment in the value of goodwill.

The changes in the carrying amount of goodwill for the quarter ended September 30, 2010, are as follows (in thousands):

Balance as of December 31, 2009	\$22,468
Goodwill recorded during the period	-
Impairment losses	-
Balance as of September 30, 2010	\$22,468

Core deposit intangible assets resulting from an acquisition were originally recorded at \$3,112,000 in April 2006, and are being amortized over 99 months. The net core deposit intangible at September 30, 2010 was \$1,415,000.

## 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 and 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 have floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Customer repurchase agreements were \$54,285,000 at September 30, 2010 and \$65,929,000 at December 31, 2009.

## 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, 2010, \$91,665,000 in 1-4 family residential mortgage loans and \$60,091,000 in home equity lines of credit were pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of September 30, 2010 and December 31, 2009 (in thousands):

Due by	September 30, 2010		Due by	December 31, 2009	
	Advance Amount	Weighted Average Rate		Advance Amount	Weighted Average Rate
March 2011	\$ 8,000	2.93	March 2011	\$ 8,000	2.93
April 2014	525	3.78	April 2014	638	3.78
	\$ 8,525	2.98 %		\$ 8,638	2.99 %



Index

In the regular course of conducting its business, the Company takes deposits from political subdivisions of Virginia and North Carolina. At September 30, 2010, the Bank's public deposits totaled \$70,665,000. 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, agency, or GSE bonds or letters of credit from the FHLB. At September 30, 2010, the Company had \$20 million in letters of credit with the FHLB outstanding to provide collateral for such deposits. The Company had also pledged \$86,789,000 of its investment portfolio for the same purpose.

## 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 September 30, 2036, but may be redeemed at the Company's option beginning on September 30, 2011. The securities require quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective September 30, 2011, the rate will reset quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to twenty consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of \$619,000 received by the Trust from the issuance of common securities by the Trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a Junior Subordinated Indenture entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company and for general corporate purposes. In accordance with FASB ASC 810-10-15-14, the Corporation did not eliminate through consolidation the Corporation's \$619,000 equity investment in AMNB Statutory Trust I. Instead, the Corporation reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

## Note 10 – Share Based Compensation

## Stock Options

A summary of stock option transactions for the nine months ended September 30, 2010, is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Average Intrinsic Value (\$000)
Outstanding at December 31, 2009	162,603	\$ 21.39		
Granted	-	-		
Exercised	(2,855 )	16.33		
Forfeited	(200 )	24.50		
Outstanding at September 30, 2010	159,548	\$ 21.48	4.9	\$ 348
Exercisable at September 30, 2010	129,048	\$ 22.57	4.1	\$ 194

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, 2010, there was \$79,000 in total unrecognized

compensation expense related to nonvested stock option grants.

15

---

Index

## 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 stock. The value of the stock awarded is established as the fair market value of the stock at the time of the grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants.

The Company made its first restricted grant to executive officers in the first quarter 2010. These grants cliff vest over a 24 month period. On January 19, 2010, the Company issued 8,712 shares of restricted stock to its six executive officers and three regional executives.

Nonvested restricted stock for the nine months ended September 30, 2010 is summarized in the following table.

Restricted Stock	Shares	Grant date fair value
Nonvested at January 1, 2010	-	-
Granted	8,712	\$ 21.36
Vested	-	-
Forfeited	-	-
Nonvested at September 30, 2010	8,712	\$ 21.36

As of September 30, 2010, there was \$116,000 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 has begun 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. Eight of twelve directors elected to receive stock in lieu of cash for their retainer fees. Only outside directors receive board fees. The Company issued 4,472 shares and recognized share based compensation expense of \$90,000 during the nine-month period.

## 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.

	2010		Three Months Ended September 30, 2009	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	6,125,359	\$ .36	6,104,505	\$ .36
Effect of dilutive securities - stock options	5,770	-	7,408	(.01 )

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

Diluted	6,131,129	\$ .36	6,111,913	\$ .35
---------	-----------	--------	-----------	--------

	Nine Months Ended September 30,			
	2010		2009	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	6,122,876	\$ 1.05	6,094,261	\$ .76
Effect of dilutive securities - stock options	5,605	-	3,960	-
Diluted	6,128,481	\$ 1.05	6,098,221	\$ .76

Stock options on common stock which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2010 and 2009, because their effects were antidilutive, averaged 82,627 and 82,827, respectively.

Index

## Note 12 – Employee Benefit Plans

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

Components of Net Periodic Benefit Cost (in thousands)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Service cost	\$ 23	\$ 184	\$ 69	\$ 552
Interest cost	117	146	351	438
Expected return on plan assets	(135 )	(203 )	(405 )	(609 )
Recognized net actuarial loss	57	111	171	333
Net periodic benefit cost	\$ 62	\$ 238	\$ 186	\$ 714

The Company’s does not anticipate contributing to the plan for 2010.

## 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 receiving 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.

Segment information as of and for the nine month periods ended September 30, 2010 and 2009, is shown in the following table.



Index

## Nine Months Ended September 30, 2010

(in thousands)	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 27,044	\$ -	\$ 103	\$ (103 )	\$ 27,044
Interest expense	5,596	-	1,030	(103 )	6,523
Noninterest income	3,370	2,528	31	-	5,929
Operating income before income taxes	8,243	1,659	(1,083 )	-	8,819
Depreciation and amortization	1,211	13	-	-	1,224
Total assets	823,582	-	635	-	824,217
Capital expenditures	1,887	1	-	-	1,888

## Nine Months Ended September 30, 2009

(in thousands)	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 28,804	\$ -	\$ 217	\$ (217 )	\$ 28,804
Interest expense	7,669	-	1,030	(217 )	8,482
Noninterest income	2,571	2,491	44	-	5,106
Operating income before income taxes	5,685	1,629	(1,014 )	-	6,300
Depreciation and amortization	1,146	12	2	-	1,160
Total assets	809,605	-	741	-	810,346
Capital expenditures	3,117	21	-	-	3,138

## Three Months Ended September 30, 2010

(in thousands)	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 8,982	\$ -	\$ 29	\$ (29 )	\$ 8,982
Interest expense	1,909	-	343	(29 )	2,223
Noninterest income	1,364	872	10	-	2,246
Operating income before income taxes	2,796	579	(341 )	-	3,034
Depreciation and amortization	394	5	-	-	399
Total assets	823,582	-	635	-	824,217
Capital expenditures	789	-	-	-	789

## Three Months Ended September 30, 2009

(in thousands)	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 9,464	\$ -	\$ 58	\$ (58 )	\$ 9,464
Interest expense	2,179	-	343	(58 )	2,464
Noninterest income	1,266	837	16	-	2,119

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

Operating income before					
income taxes	2,807	566	(344 )	-	3,029
Depreciation and amortization	400	4	1	-	405
Total assets	809,605	-	741	-	810,346
Capital expenditures	776	13	-	-	789

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 following table. The Company has one private label collateralized mortgage obligation, shown in the following table, upon which \$31,000 in other than temporary impairment was recognized in the first quarter of 2010. The Company has engaged an independent, outside appraisal firm to assist with quarterly valuations of the security to determine an estimate Hold to Maturity Price based on periodic assessments of loss severity, default rates and prepayment rates. The valuations of these Level 3 securities are highly complex and judgmental.

Index

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2010 (in thousands):

Description	Fair Value Measurements at September 30, 2010 Using			
	Balance as of September 30, 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	\$ 209,434	\$ -	\$ 209,021	\$ 413

Description	Fair Value Measurements at December 31, 2009 Using			
	Balance as of December 31, 2009	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	\$ 188,795	\$ -	\$ 188,795	\$ -

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.

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 year ended September 30, 2010. 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. 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.

Index

Other real estate owned: Certain assets such as other real estate owned (“OREO”) are measured at fair value less cost to sell. A third party appraisal is obtained once the property becomes OREO to determine the fair value. 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	Fair Value Measurements at September 30, 2010			
	Balance as of September 30, 2010	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Other real estate owned	\$ 3,987	\$ -	\$ 3,987	\$ -

Description	Fair Value Measurements at December 31, 2009			
	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Impaired loans, net of valuation allowance	\$ 488	\$ -	\$ 488	\$ -
Other real estate owned	3,414	-	3,414	-

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)  
Total Realized / Unrealized Gains  
(Losses) Included in

	Balances as of January 1, 2010	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances and Settlements, Net	Transfer In (Out) of Level 3	Balances as of September 30, 2010
Securities available for sale						
Private label Collateralized Mortgage Obligation (ARM)	\$-	\$(31)	\$(192)	\$(48)	\$684	\$413

Total assets	\$-	\$(31	)	\$(192	)	\$(48	)	\$684	\$413
--------------	-----	-------	---	--------	---	-------	---	-------	-------



Index

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

(in thousands)	September 30, 2010		December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	\$ 27,198	\$ 27,198	\$ 23,943	\$ 23,943
Securities available for sale	209,434	209,434	188,795	188,795
Securities held to maturity	4,501	4,675	6,529	6,763
Loans held for sale	3,952	3,952	2,490	2,490
Loans, net of allowance	510,879	515,808	519,825	528,631
Accrued interest receivable	3,747	3,747	3,268	3,268
Financial liabilities:				
Deposits	\$ 625,630	\$ 627,927	\$ 604,273	\$ 607,015
Repurchase agreements	54,285	54,285	65,929	65,929
Other borrowings	8,525	8,523	8,638	8,620
Trust preferred capital notes	20,619	20,532	20,619	20,640
Accrued interest payable	789	789	899	899

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.

Index

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, 2010 and December 31, 2009, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

The Company assumes interest rate risk 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

	Nine Months Ended September 30,	
	2010	2009
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$ 10,860	\$ 17,451
Interest-bearing deposits in other banks	16,338	8,892
	\$ 27,198	\$ 26,343
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	\$ 6,572	\$ 8,825
Income taxes	2,488	1,615
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	1,008	1,786
Unrealized gain on securities available for sale	3,114	2,801

## 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") (collectively referred to as the "Company"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Forward-looking statements are subject to numerous assumptions, estimates, risks, and uncertainties that could cause actual conditions, events, or results to differ materially from those stated or implied by such forward-looking statements.

A variety of factors may affect the operations, performance, business strategy, and results of the Company. Those factors include, but are not limited to the following:

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

#### Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2010 presentation.

#### Critical Accounting Policies

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses and (2) goodwill impairment. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements in the Company's 2009 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.

## Index

### 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: FASB Topic 450-25 Contingencies - Recognition which requires that losses be accrued when they are probable of occurring and estimable and 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.

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 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 (except the consumer segment allowance which is calculated by multiplying the period-end balances by an adjusted loss factor without regard to risk grades). 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 values is inherently subjective and actual losses could be greater or less than the estimates.

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

### Goodwill Impairment

The Company tests goodwill on an annual basis or more frequently if events or circumstances indicate that there may have been impairment. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss in an amount equal to that excess. The goodwill impairment test requires management to make judgments in determining the assumptions used in the calculations. The goodwill impairment testing conducted by the Company in 2010 indicated that goodwill is not impaired and is properly recorded in the financial statements. No events or circumstances since December 31, 2009 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 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

## RESULTS OF OPERATIONS

## Earnings Performance

Three months ended September 30, 2010 and 2009

For the quarter ended September 30, 2010, the Company reported net income of \$2,228,000 compared to \$2,167,000 for the comparable quarter in 2009. The \$61,000 or 2.8% increase in earnings was primarily due to:

- a \$241,000 decrease in net interest income, related mostly to declining loan and bond yields,
- a \$57,000 decrease in provision for loan losses, directionally consistent with the overall decrease in loan volume,
- a \$127,000 increase in noninterest income, related to increased secondary market mortgage income, trust income, and a gain on sale of securities, and
  - a \$62,000 decrease in expenses, related mostly to reductions in benefits costs.

SUMMARY INCOME  
STATEMENT

(dollars in thousands)

For the three months ended September 30,	2010	2009	\$ Change	%	Change
Interest income	\$ 8,982	\$ 9,464	\$ (482 )	-5.1	%
Interest expense	(2,223 )	(2,464 )	241	-9.8	%
Net interest income	6,759	7,000	(241 )	-3.4	%
Provision for loan losses	(435 )	(492 )	57	-11.6	%
Noninterest income	2,246	2,119	127	6.0	%
Noninterest expense	(5,536 )	(5,598 )	62	-1.1	%
Income tax expense	(806 )	(862 )	56	-6.5	%
<b>Net income</b>	<b>\$ 2,228</b>	<b>\$ 2,167</b>	<b>\$ 61</b>	<b>2.8</b>	<b>%</b>

Nine months ended September 30, 2010 and 2009

For the nine month period ended September 30, 2010, the Company reported net income of \$6,427,000 compared to \$4,641,000 for the comparable quarter in 2009. The \$1,786,000 or 38.5% increase in earnings was due to:

- an \$199,000 increase in net interest income, related mostly to declining deposit rates,
- a \$329,000 decrease in provision for loan losses, directionally consistent with the overall decrease in loan volume,
- a \$823,000 increase in noninterest income, related to a \$1.2 million other real estate write down in the 2009 period, and



- a \$1,168,000 decrease in expenses, related to reductions in personnel and benefits costs and to the FDIC special assessment levied in the 2009 period.

IndexIndex

SUMMARY INCOME  
STATEMENT  
(dollars in thousands)

For the nine months ended September 30,	2010	2009	\$ Change	%	Change
Interest income	\$ 27,044	\$ 28,804	\$ (1,760 )	-6.1	%
Interest expense	(6,523 )	(8,482 )	1,959	-23.1	%
Net interest income	20,521	20,322	199	1.0	%
Provision for loan losses	(1,005 )	(1,334 )	329	-24.7	%
Noninterest income	5,929	5,106	823	16.1	%
Noninterest expense	(16,626)	(17,794)	1,168	-6.6	%
Income tax expense	(2,392 )	(1,659 )	(733 )	44.2	%
<b>Net income</b>	<b>\$ 6,427</b>	<b>\$ 4,641</b>	<b>\$ 1,786</b>	<b>38.5</b>	<b>%</b>

## 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, 2010 and 2009

Net interest income on a taxable equivalent basis decreased \$128,000 or 1.8%, for the third quarter of 2010 compared to the same quarter of 2009. Changes in the rates paid and yields earned were the primary drivers of this change in net interest income, as indicated by the Rate/Volume Analysis shown later in this section.

For the third quarter of 2010 and 2009, the Company's yield on earnings assets was 4.89% compared to 5.24%. The cost of interest bearing liabilities was 1.43% compared to 1.65%. The interest rate spread was 3.46% compared to 3.59%. The net interest margin, on a fully taxable equivalent basis, was 3.74% compared to 3.91%. Yields and rates generally fell between periods. Declining yields on earning assets and balance shifts between loans and relatively lower yielding bonds contributed to the decrease in net interest margin.

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, 2010 and 2009. 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.



Index

Net Interest Income Analysis  
For the Three Months Ended September 30, 2010 and 2009  
(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2010	2009	2010	2009	2010	2009
<b>Loans:</b>						
Commercial	\$ 76,618	\$ 85,894	\$ 934	\$ 1,027	4.84 %	4.78 %
Real estate	441,069	460,253	5,968	6,508	5.41	5.66
Consumer	6,405	7,468	126	158	7.80	8.46
Total loans	524,092	553,615	7,028	7,693	5.36	5.56
<b>Securities:</b>						
Federal agencies	60,079	56,706	459	538	3.06	3.80
Mortgage-backed & CMO's	53,839	37,609	493	506	3.66	5.38
State and municipal	94,419	56,665	1,217	798	5.16	5.63
Other	6,195	8,334	55	80	3.55	3.84
Total securities	214,532	159,314	2,224	1,922	4.15	4.83
Deposits in other banks	24,118	28,265	90	96	1.48	1.36
Total interest-earning assets	762,742	741,194	9,342	9,711	4.89	5.24
Non-earning assets	73,291	68,870				
Total assets	\$ 836,033	\$ 810,064				
<b>Deposits:</b>						
Demand	\$ 90,731	\$ 94,869	16	31	0.07	0.13
Money market	70,011	76,416	94	107	0.53	0.56
Savings	63,562	62,985	22	38	0.14	0.24
Time	305,887	269,523	1,590	1,745	2.06	2.59
Total deposits	530,191	503,793	1,722	1,921	1.29	1.53
Customer repurchase agreements	59,126	65,341	93	134	0.62	0.82
Other short-term borrowings	92	460	0	1	0.43	0.87
Long-term borrowings	29,174	29,325	408	408	5.59	5.57
Total interest-bearing liabilities	618,583	598,919	2,223	2,464	1.43	1.65

Noninterest bearing demand deposits	103,501	102,341		
Other liabilities	4,064	5,393		
Shareholders' equity	109,885	103,411		
Total liabilities and shareholders' equity	\$ 836,033	\$ 810,064		
Interest rate spread			3.46 %	3.59 %
Net interest margin			3.74 %	3.91 %
Net interest income (taxable equivalent basis)		7,119	7,247	
Less: Taxable equivalent adjustment		360	247	
Net interest income		\$ 6,759	\$ 7,000	

Index

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

Interest income	Three months ended September 30 2010 vs. 2009		
	Interest Increase (Decrease)	Change Attributable to	
		Rate	Volume
<b>Loans:</b>			
Commercial	\$ (93 )	\$ 20	\$ (113 )
Real Estate	(540 )	(274 )	(266 )
Consumer	(32 )	(11 )	(21 )
Total loans	(665 )	(265 )	(400 )
<b>Securities:</b>			
Federal agencies	(79 )	(110 )	31
Mortgage-backed	(13 )	(191 )	178
State and municipal	419	(73 )	492
Other securities	(25 )	(6 )	(19 )
Total securities	302	(380 )	682
Deposits in other banks	(6 )	9	(15 )
Total interest income	(369 )	(636 )	267
<b>Interest expense</b>			
<b>Deposits:</b>			
Demand	(15 )	(14 )	(1 )
Money market	(13 )	(4 )	(9 )
Savings	(16 )	(16 )	-
Time	(155 )	(372 )	217
Total deposits	(199 )	(406 )	207
Customer repurchase agreements	(41 )	(29 )	(12 )
Other borrowings	(1 )	6	(7 )
Total interest expense	(241 )	(429 )	188
Net interest income	\$ (128 )	\$ (207 )	\$ 79

Nine months ended September 30, 2010 and 2009

Net interest income on a taxable equivalent basis increased \$461,000 or 2.2%, for the nine months ended September 30, 2010 compared to the comparable period in 2009.

For the first nine months of 2010 and 2009, the Company's yield on earnings assets was 4.98% compared to 5.31%. The cost of interest bearing liabilities was 1.43% compared to 1.88%. The interest rate spread was 3.55% compared to 3.43%. The net interest margin, on a fully taxable equivalent basis, was 3.82% compared to 3.79%. Yields and rates generally fell between periods, but most of the improvement in spread and margin was related to reductions in liability pricing, notably time deposits, which more than offset declines in income from decreased yields and shifts of balances to lower earning assets.

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, 2010 and 2009. 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.

Index

Net Interest Income Analysis  
For the Nine Months Ended September 30, 2010 and 2009  
(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2010	2009	2010	2009	2010	2009
<b>Loans:</b>						
Commercial	\$ 78,180	\$ 91,193	\$ 2,826	\$ 3,227	4.83 %	4.72 %
Real estate	438,736	466,787	18,096	19,956	5.50	5.70
Consumer	6,553	7,746	397	511	8.10	8.80
Total loans	523,469	565,726	21,319	23,694	5.43	5.58
<b>Securities:</b>						
Federal agencies	63,929	49,606	1,535	1,584	3.20	4.26
Mortgage-backed & CMO's	47,795	41,158	1,473	1,618	4.11	5.24
State and municipal	80,625	50,439	3,223	2,133	5.33	5.64
Other	6,933	7,212	185	185	3.56	3.42
Total securities	199,282	148,415	6,416	5,520	4.29	4.96
Deposits in other banks	26,754	26,258	268	287	1.34	1.46
Total interest-earning assets	749,505	740,399	28,003	29,501	4.98	5.31
Non-earning assets	72,356	68,362				
Total assets	\$ 821,861	\$ 808,761				
<b>Deposits:</b>						
Demand	\$ 94,607	\$ 99,860	58	263	0.08	0.35
Money market	77,691	73,112	285	453	0.49	0.83
Savings	63,644	62,284	66	115	0.14	0.25
Time	281,601	274,214	4,595	5,797	2.18	2.82
Total deposits	517,543	509,470	5,004	6,628	1.29	1.73
Customer repurchase agreements	61,698	60,790	297	543	0.64	1.19
Other short-term borrowings	31	1,355	0	5	0.43	0.49
Long-term borrowings	29,211	31,376	1,222	1,306	5.58	5.55



Total interest-bearing liabilities	608,483	602,991	6,523	8,482	1.43	1.88
Noninterest bearing demand deposits	100,965	97,970				
Other liabilities	3,901	4,740				
Shareholders' equity	108,512	103,060				
Total liabilities and shareholders' equity	\$ 821,861	\$ 808,761				
Interest rate spread					3.55 %	3.43 %
Net interest margin					3.82 %	3.79 %
Net interest income (taxable equivalent basis)			21,480	21,019		
Less: Taxable equivalent adjustment			959	697		
Net interest income			\$ 20,521	\$ 20,322		

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

Interest income	Nine months ended September 30 2010 vs. 2009		
	Interest Increase (Decrease)	Change Attributable to Rate	Volume
<b>Loans:</b>			
Commercial	\$ (401 )	\$ 68	\$ (469 )
Real Estate	(1,860 )	(687 )	(1,173 )
Consumer	(114 )	(39 )	(75 )
Total loans	(2,375 )	(658 )	(1,717 )
<b>Securities:</b>			
Federal agencies	(49 )	(445 )	396
Mortgage-backed	(145 )	(382 )	237
State and municipal	1,090	(123 )	1,213
Other securities	-	7	(7 )
Total securities	896	(943 )	1,839
Deposits in other banks	(19 )	(24 )	5
Total interest income	(1,498 )	(1,625 )	127
<b>Interest expense</b>			
<b>Deposits:</b>			
Demand	(205 )	(192 )	(13 )
Money market	(168 )	(195 )	27
Savings	(49 )	(51 )	2
Time	(1,202 )	(1,354 )	152
Total deposits	(1,624 )	(1,792 )	168
Repurchase agreements	(246 )	(254 )	8
Other borrowings	(89 )	55	(144 )
Total interest expense	(1,959 )	(1,991 )	32
Net interest income	\$ 461	\$ 366	\$ 95

## Noninterest Income

All comparisons discussed below are between the third quarter 2010 and the third quarter of 2009, unless otherwise noted.

Noninterest income increased to \$2,246,000 in 2010 from \$2,119,000 in 2009, a \$127,000 or 6% improvement. The major factors impacting that change are discussed below.

Fees from the management of trusts, estates, and asset management accounts increased to \$842,000 in 2010 from \$813,000 in 2009, a \$29,000 or 3.6% 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.

Service charges on deposit accounts decreased to \$478,000 in 2010 from \$536,000 in 2009, a \$58,000 or 10.8% decline. This reduction was primarily the result of lower deposit account fee volume.

Index

Other fees and commissions increased to \$290,000 in 2010 from \$257,000 in 2009, an increase of \$33,000 or 12.8% due primarily to increases in VISA check card income. Management expects this income category will decline after implementation of recent banking reform legislation, which is expected to have a negative impact on electronic banking fee income.

Mortgage banking income increased to \$428,000 in 2010 from \$361,000 in 2009, an improvement of \$67,000 or 18.6%. This business slowed with the expiration of the home buyer tax credit and the overall slowdown in the real estate market, but historically low mortgage rates have fueled demand for refinanced mortgages from qualified borrowers.

Securities gains increased to \$67,000 for 2010 from \$1,000 in 2009. This change was related to the sale of approximately \$1 million in mortgage backed pass-through securities, the aggregate total of 16 individual bonds.

Foreclosed real estate losses were \$5,000 for 2010 compared to \$0 in 2009.

Noninterest income for the nine month period ended September 30, 2010 increased to \$5,929,000 compared to \$5,106,000 for the 2009 period, an \$823,000 or 16.1% increase. The biggest driver in this improvement was a \$1.2 million other real estate write down, which negatively impacted the 2009 period.

Noninterest Expense

All comparisons discussed below are between the third quarter 2010 and the third quarter of 2009, unless otherwise noted.

Noninterest expense was \$5,536,000 for 2010 compared to \$5,598,000 for 2009, a \$62,000 or 1.1% decrease. The major factors impacting that change are discussed below.

Salaries were \$2,596,000 for 2010 compared to \$2,471,000 for 2009, a \$125,000 or 5.1% increase. This is primarily the result of normal payroll increases and staffing changes.

Employee benefits were \$564,000 for 2010 compared to \$806,000 for 2009, a \$242,000 or 30% decrease. This was due primarily to the change in the Company's defined benefit plan to a cash balance plan, which was effective December 31, 2009, and reduced costs of other benefits.

The FDIC insurance assessment was \$203,000 for 2010 compared to \$203,000 for 2009, unchanged.

Noninterest expense in the nine months ended September 30, 2010 was \$16,626,000 compared to \$17,794,000 for the same period in 2009, for a decrease of \$1,168,000 or 6.6%. This decrease was the result of the same factors discussed above for the quarter.

Income Taxes

The effective tax rate for the third quarter of 2010 was 26.6% compared to 28.5% for the third quarter of 2009.

The effective tax rate for the nine months ended September 30, 2010 was 27.1% compared to 26.3% for the same period of 2009.

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. However, in early 2009, the effective tax rate was also impacted by the \$1.2 million valuation adjustment on certain foreclosed real estate.

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 very low for an extended period.

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 \$209,434,000 at September 30, 2010 compared to \$188,795,000 at December 31, 2009, a \$20,639,000 or 10.9% increase.

The held to maturity securities portfolio decreased to \$4,501,000 at September 30, 2010 from \$6,529,000 at December 31, 2009, a \$2,028,000 or 31.1% decline. As a practical matter, any new security purchase is classified as available for sale.

At September 30, 2010, the available for sale portfolio had an estimated fair value of \$209,434,000 and an amortized cost of \$202,165,000, resulting in a net unrealized gain of \$7,269,000.

At the same dates, the held to maturity portfolio had an estimated fair value of \$4,675,000 and an amortized cost of \$4,501,000, resulting in a net unrealized gain of \$174,000.

At September 30, 2010, mortgage-backed securities consist principally of obligations of U.S. Government sponsored enterprises. CMOs (collateralized mortgage obligations) issued by non-U.S. Government sponsored enterprises, as of September 30, 2010, had an amortized cost of \$1,849,000 and an estimated fair value of \$1,644,000; resulting in an estimated net unrealized loss of \$205,000. One of these bonds, with a \$605,000 book value was downgraded in the first quarter by Standard and Poor's to CCC status. After reviewing the security, management elected to take an OTTI charge of \$31,000 against the bond. The current estimated market value of the security is \$413,000, resulting in an estimated unrealized loss of \$192,000.

## Index

The current economic challenges on a local, regional and national level have resulted in a significant slowdown in business activity throughout 2009 and continuing into 2010. This slowdown has manifested itself on the Company's balance sheet with a moderate reduction in the size of our loan portfolio, a slight increase in deposits and a substantial increase in our investment portfolio. 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 similar termed taxable investments.

## Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans, construction and land development loans, and home equity loans. Loans were \$519,421,000 at September 30, 2010 compared to \$527,991,000 at December 31, 2009, an \$8,570,000 or 1.6% decrease. Management considers the decline in the loan portfolio primarily the result of the current economic climate and the overall slowdown in business activity and, secondarily, the Company's deliberate decision to maintain a conservative risk profile in consideration of long term asset quality.

Management considers it noteworthy that the rapid decline in loan balances experienced in 2009 and early 2010 appear to have ceased at the end of the first quarter 2010. Average loan balances have been fairly stable in the \$520 million range for the past two quarters. Also, actual end of quarter loan balances have been up, albeit by very small amounts, for the past two quarters. Whether this indicates a bottoming out in the demand for new business credit or merely an intermission in the economic slowdown remains to be determined.

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

The allowance for loan losses was \$8,542,000 at September 30, 2010 compared to \$8,166,000 at December 31, 2009. At the same dates, the allowance was 1.64% of loans compared to 1.55%. These increases are directionally inconsistent with the change in the volume of the loan portfolio. However, management considers the size of the allowance appropriate because of continuing deterioration and negative trends in the local and regional economy, including unemployment, delinquency and foreclosure rates in Virginia and North Carolina. Management is also aware of an \$841,000 or 11.9% increase in nonaccrual loan and foreclosures since year end 2010, as indicated by the chart at the end of this section. Management is further aware of the possible financial impact of extended economic stress in our marketplace and has incorporated that into its qualitative assessment of the allowance for loan loss.

Annualized net charge-offs represented 0.02% of total loans during the third quarter of 2010 compared to 0.20% in the second quarter of 2010 and 0.12% in the third quarter of 2009.

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 nonaccrual loans and foreclosed real estate. Nonperforming assets represented 0.96% and 0.87% of total assets, respectively, at September 30, 2010 and December 31, 2009. There were no troubled debt restructurings at September 30, 2010 and December 31, 2009.





Index

The following table summarizes nonperforming assets (in thousands):

	September 30, 2010	December 31, 2009
Loans 90 days or more past due	\$ -	\$ -
Nonaccrual loans	3,910	3,642
Nonperforming loans	3,910	3,642
Foreclosed real estate	3,987	3,414
Nonperforming assets	\$ 7,897	\$ 7,056

## Premises and equipment

Premises and equipment were \$20,142,000 at September 30, 2010 compared to \$19,195,000, at December 31, 2009, a \$947,000 or 4.9% increase. Most of this increase was related to the new branch in South Boston, Virginia, which was completed and opened during the third quarter of 2010.

## Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$625,630,000 at September 30, 2010 compared to \$604,273,000 at December 31, 2009, a \$21,357,000 or 3.5% increase. The growth in deposits is related to increased volumes of retail time deposits. Core deposit growth continues to be an ongoing strategic goal and challenge for the Company and the community banking industry in general.

## 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 \$110,868,000 at September 30, 2010 compared to \$106,389,000 at December 31, 2009, an increase of \$4,479,000 or 4.2%.

The Company paid cash dividends of \$0.23 per share during the third quarter of 2010 while the basic and diluted earnings per share for the same period were \$0.36. The Company paid cash dividends of \$0.69 per share for the first nine months of 2010 while the basic and diluted earnings per share for the same period were \$1.05. The Company's current capital position provided the Board of Directors with the strategic flexibility to pay a cash dividend relatively high relative to current earnings.

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.

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, 2010, the Company's Tier I and total capital ratios were 18.35% and 19.60%, respectively. At December 31, 2009, these ratios were 17.56% and 18.82%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 12.79% and 12.81% at September 30, 2010 and December 31, 2009, 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.

Index

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, 2010, that the Company met the requirements to be considered "well capitalized."

## Off-Balance-Sheet Activities

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

	September 30, 2010	December 31, 2009
Commitments to extend credit	\$ 133,059	\$ 133,692
Standby letters of credit	2,033	2,624
Mortgage loan rate-lock commitments	10,974	2,054

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 Management 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 4.3%. 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 Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank's discount window, federal funds lines of credit from two correspondent banks, and maturities and sales of securities. Management believes that these sources provide sufficient and timely liquidity.

The Company has a line of credit with the FHLB, equal to 30% of the Company's assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges

as collateral its capital stock in and deposits with the FHLB. At September 30, 2010, principal obligations to the FHLB consisted of \$8,525,000 in fixed-rate, long-term advances compared to \$8,638,000 at December 31, 2009. The Company also had a \$20 million letter of credit outstanding at September 30, 2010 for the purpose of securing public deposits. Letters of credit provide the Bank with an alternate source of collateral, other than its bond portfolio, for securing public entity deposits above FDIC insurance levels.

Index

The Company had fixed-rate term borrowing contracts with the FHLB as of September 30, 2010, with the following final maturities (in thousands):

Amount	Maturity Date
\$4,000,000	March 2011
4,000,000	April 2011
525,000	March 2014
\$8,525,000	

The Company has federal funds lines of credit established with two other banks in the amounts of \$15,000,000 and \$10,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at September 30, 2010.

There have been no material changes to market risk as disclosed in the Company's 2009 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, 2010. 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, 2010 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

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.

1A. Risk Factors

There have been no material changes to the risk factors disclosed in the Company's 2010 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 12, 2010.

2. Unregistered Sales of Equity Securities and Use of Proceeds

None

3. Defaults Upon Senior Securities

None

4. (Removed and Reserved)

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 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

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 5, 2010

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

Date – November 5, 2010

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



Index