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**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 **March 31, 2011**.
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_ TO\_.

Commission file number: 0-12820

**AMERICAN NATIONAL BANKSHARES INC.**

(Exact name of registrant as specified in its charter)

|   |  |
|---|--|
| <u>VIRGINIA</u><br>(State or other jurisdiction of<br>incorporation or organization)      | <u>54-1284688</u><br>(I.R.S. Employer<br>Identification No.) |
| <u>628 Main Street<br/>Danville, Virginia</u><br>(Address of principal executive offices) | <u>24541</u><br>(Zip Code)                                   |

(434) 792-5111

(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

At May 6, 2011, the Company had 6,153,433 shares of Common Stock outstanding, \$1 par value.

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**American National Bankshares Inc. and Subsidiaries**  
**Consolidated Balance Sheets**

*(Dollars in thousands, except share data)*

|   | (Unaudited)<br>March 31,<br>2011 | (Audited)<br>December<br>31,<br>2010 |
|---|----------------------------------|--------------------------------------|
| <b>ASSETS</b>   |                                  |                                      |
| Cash and due from banks   | \$ 14,248                        | \$ 9,547                             |
| Interest-bearing deposits in other banks  | 25,397                           | 8,967                                |
| Securities available for sale, at fair value  | 226,171                          | 228,295                              |
| Securities held to maturity (fair value of \$3,236 at 3/31/11 and \$3,440 at 12/31/10)  | 3,146                            | 3,334                                |
| Total securities  | <u>229,317</u>                   | <u>231,629</u>                       |
| Restricted stock, at cost   | 4,062                            | 4,062                                |
| Loans held for sale   | 1,309                            | 3,135                                |
| Loans, net of unearned income   | 516,629                          | 520,781                              |
| Less allowance for loan losses  | (8,257)                          | (8,420)                              |
| Net loans   | <u>508,372</u>                   | <u>512,361</u>                       |
| Premises and equipment, net   | 19,308                           | 19,509                               |
| Other real estate owned, net  | 3,532                            | 3,716                                |
| Goodwill  | 22,468                           | 22,468                               |
| Core deposit intangibles, net   | 1,226                            | 1,320                                |
| Accrued interest receivable and other assets  | 15,999                           | 16,950                               |
| Total assets  | <u>\$ 845,238</u>                | <u>\$ 833,664</u>                    |
| <b>LIABILITIES and SHAREHOLDERS' EQUITY</b>   |                                  |                                      |
| Liabilities:  |                                  |                                      |
| Demand deposits -- noninterest bearing  | \$ 117,260                       | \$ 105,240                           |
| Demand deposits -- interest bearing   | 96,686                           | 90,012                               |
| Money market deposits   | 57,530                           | 59,891                               |
| Savings deposits  | 63,236                           | 62,522                               |
| Time deposits   | 328,771                          | 322,433                              |
| Total deposits  | <u>663,483</u>                   | <u>640,098</u>                       |
| Short-term borrowings:  |                                  |                                      |
| Customer repurchase agreements  | 43,871                           | 47,084                               |
| Other short-term borrowings   | -                                | 6,110                                |
| Long-term borrowings  | 4,450                            | 8,488                                |
| Trust preferred capital notes   | 20,619                           | 20,619                               |
| Accrued interest payable and other liabilities  | 3,443                            | 3,178                                |
| Total liabilities   | <u>735,866</u>                   | <u>725,577</u>                       |
| Shareholders' equity:   |                                  |                                      |
| Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding   | -                                | -                                    |
| Common stock, \$1 par, 20,000,000 shares authorized, 6,153,433 shares outstanding at March 31, 2011 and 6,127,735 shares outstanding at December 31, 2010 | 6,153                            | 6,128                                |
| Capital in excess of par value  | 27,541                           | 27,268                               |
| Retained earnings   | 75,214                           | 74,850                               |
| Accumulated other comprehensive income (loss), net  | 464                              | (159)                                |
| Total shareholders' equity  | <u>109,372</u>                   | <u>108,087</u>                       |
| Total liabilities and shareholders' equity  | <u>\$ 845,238</u>                | <u>\$ 833,664</u>                    |

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

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

|  | Three Months Ended<br>March 31 |                 |
|--|--------------------------------|-----------------|
|  | 2011                           | 2010            |
| <b>Interest and Dividend Income:</b>                       |                                |                 |
| Interest and fees on loans                                 | \$ 6,679                       | \$ 7,155        |
| Interest and dividends on securities:                      |                                |                 |
| Taxable  | 1,169                          | 1,316           |
| Tax-exempt   | 716                            | 466             |
| Dividends  | 27                             | 23              |
| Other interest income                                      | 70                             | 91              |
| Total interest and dividend income                         | <u>8,661</u>                   | <u>9,051</u>    |
| <b>Interest Expense:</b>                                   |                                |                 |
| Interest on deposits                                       | 1,580                          | 1,635           |
| Interest on short-term borrowings                          | 80                             | 105             |
| Interest on long-term borrowings                           | 53                             | 64              |
| Interest on trust preferred capital notes                  | 343                            | 343             |
| Total interest expense                                     | <u>2,056</u>                   | <u>2,147</u>    |
| <b>Net Interest Income</b>                                 | 6,605                          | 6,904           |
| Provision for Loan Losses                                  | <u>337</u>                     | <u>285</u>      |
| <b>Net Interest Income After Provision for Loan Losses</b> | <u>6,268</u>                   | <u>6,619</u>    |
| <b>Noninterest Income:</b>                                 |                                |                 |
| Trust fees   | 928                            | 812             |
| Service charges on deposit accounts                        | 421                            | 479             |
| Other fees and commissions                                 | 316                            | 278             |
| Mortgage banking income                                    | 147                            | 246             |
| Securities gains (losses), net                             | 1                              | (29)            |
| Other  | 158                            | 138             |
| Total noninterest income                                   | <u>1,971</u>                   | <u>1,924</u>    |
| <b>Noninterest Expense:</b>                                |                                |                 |
| Salaries   | 2,485                          | 2,398           |
| Employee benefits  | 541                            | 640             |
| Occupancy and equipment                                    | 699                            | 779             |
| FDIC assessment  | 205                            | 195             |
| Bank franchise tax   | 175                            | 167             |
| Core deposit intangible amortization                       | 94                             | 94              |
| Foreclosed real estate, net                                | 22                             | 3               |
| Other  | 1,558                          | 1,224           |
| Total noninterest expense                                  | <u>5,779</u>                   | <u>5,500</u>    |
| Income Before Income Taxes                                 | 2,460                          | 3,043           |
| Income Taxes   | <u>682</u>                     | <u>858</u>      |
| <b>Net Income</b>  | <u>\$ 1,778</u>                | <u>\$ 2,185</u> |
| <b>Net Income Per Common Share:</b>                        |                                |                 |
| Basic  | \$ 0.29                        | \$ 0.36         |
| Diluted  | \$ 0.29                        | \$ 0.36         |
| <b>Average Common Shares Outstanding:</b>                  |                                |                 |
| Basic  | 6,143,602                      | 6,119,415       |
| Diluted  | 6,152,738                      | 6,124,306       |

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

**American National Bankshares Inc. and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**

Three Months Ended March 31, 2011 and 2010

(Dollars in thousands) (Unaudited)

|  | Common Stock     |                 | Capital in<br>Excess of<br>Par Value | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|--|------------------|-----------------|--------------------------------------|----------------------|--|----------------------------------|
|  | Shares           | Amount          |                                      |                      |  |                                  |
| <b>Balance, December 31, 2009</b>  | 6,110,335        | \$ 6,110        | \$ 26,962                            | \$ 72,208            | \$ 1,109   | \$ 106,389                       |
| Net income   | -                | -               | -                                    | 2,185                | -  | 2,185                            |
| Change in unrealized losses on securities available for sale, net of tax, \$(64)                 | -                | -               | -                                    | -                    | (116)  |                                  |
| 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 \$ 0 | -                | -               | -                                    | -                    | (2)  |                                  |
| Other comprehensive loss   |                  |                 |                                      |                      | (98)   | (98)                             |
| Total comprehensive income   |                  |                 |                                      |                      |  | 2,087                            |
| Stock options exercised  | 2,764            | 3               | 42                                   | -                    | -  | 45                               |
| Stock option expense   | -                | -               | 16                                   | -                    | -  | 16                               |
| Equity based compensation  | 10,176           | 10              | 43                                   | -                    | -  | 53                               |
| Cash dividends declared, \$0.23 per share  | -                | -               | -                                    | (1,408)              | -  | (1,408)                          |
| <b>Balance, March 31, 2010</b>   | <u>6,123,275</u> | <u>\$ 6,123</u> | <u>\$ 27,063</u>                     | <u>\$ 72,985</u>     | <u>\$ 1,011</u>  | <u>\$ 107,182</u>                |
| <b>Balance, December 31, 2010</b>  | 6,127,735        | \$ 6,128        | \$ 27,268                            | \$ 74,850            | \$ (159)   | \$ 108,087                       |
| Net income   | -                | -               | -                                    | 1,778                | -  | 1,778                            |
| Change in unrealized gains on securities available for sale, net of tax, \$336                   | -                | -               | -                                    | -                    | 624  |                                  |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$0  | -                | -               | -                                    | -                    | (1)  |                                  |
| Other comprehensive income   |                  |                 |                                      |                      | 623  | 623                              |
| Total comprehensive income   |                  |                 |                                      |                      |  | 2,401                            |
| Stock options exercised  | 10,510           | 10              | 162                                  | -                    | -  | 172                              |
| Stock option expense   | -                | -               | 16                                   | -                    | -  | 16                               |
| Equity based compensation  | 15,188           | 15              | 95                                   | -                    | -  | 110                              |

Cash dividends declared, \$0.23  
per share

|  |          |          |                |          |                |
|--|----------|----------|----------------|----------|----------------|
|  | <u>-</u> | <u>-</u> | <u>(1,414)</u> | <u>-</u> | <u>(1,414)</u> |
|--|----------|----------|----------------|----------|----------------|

|                                |                  |                 |                  |                  |               |                   |
|--------------------------------|------------------|-----------------|------------------|------------------|---------------|-------------------|
| <b>Balance, March 31, 2011</b> | <u>6,153,433</u> | <u>\$ 6,153</u> | <u>\$ 27,541</u> | <u>\$ 75,214</u> | <u>\$ 464</u> | <u>\$ 109,372</u> |
|--------------------------------|------------------|-----------------|------------------|------------------|---------------|-------------------|

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

**American National Bankshares Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
Three Months Ended March 31, 2011 and 2010  
(Dollars in thousands) (Unaudited)

|   | 2011             | 2010             |
|---|------------------|------------------|
| <b>Cash Flows from Operating Activities:</b>                                      |                  |                  |
| Net income  | \$ 1,778         | \$ 2,185         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Provision for loan losses   | 337              | 285              |
| Depreciation  | 304              | 323              |
| Core deposit intangible amortization  | 94               | 94               |
| Net amortization of securities  | 267              | 41               |
| Net gain on sale or call of securities  | (1)              | (2)              |
| Impairment of securities  | -                | 31               |
| Gain on sale of loans held for sale   | (123)            | (222)            |
| Proceeds from sales of loans held for sale  | 8,678            | 9,893            |
| Originations of loans held for sale   | (6,729)          | (9,389)          |
| Net loss on sale of foreclosed real estate  | 12               | 3                |
| Net change in valuation allowance on foreclosed real estate                       | 10               | -                |
| Stock-based compensation expense  | 16               | 16               |
| Equity based compensation expense   | 110              | 53               |
| Deferred income tax expense (benefit)   | 41               | (300)            |
| Net change in interest receivable   | 348              | (175)            |
| Net change in other assets  | 226              | 235              |
| Net change in interest payable  | (77)             | (31)             |
| Net change in other liabilities   | 342              | 1,256            |
| Net cash provided by operating activities   | <u>5,633</u>     | <u>4,296</u>     |
| <b>Cash Flows from Investing Activities:</b>                                      |                  |                  |
| Proceeds from maturities and calls of securities available for sale               | 29,423           | 33,857           |
| Proceeds from maturities and calls of securities held to maturity                 | 190              | 727              |
| Purchases of securities available for sale  | (26,608)         | (36,232)         |
| Net change in loans   | 3,474            | 11,760           |
| Purchases of bank property and equipment  | (103)            | (273)            |
| Proceeds from sales of foreclosed real estate                                     | 340              | 122              |
| Net cash provided by investing activities   | <u>6,716</u>     | <u>9,961</u>     |
| <b>Cash Flows from Financing Activities:</b>                                      |                  |                  |
| Net change in demand, money market, and savings deposits                          | 17,047           | 7,917            |
| Net change in time deposits   | 6,338            | (2,569)          |
| Net change in repurchase agreements   | (3,213)          | (5,557)          |
| Net change in short-term borrowings   | (6,110)          | -                |
| Net change in long-term borrowings  | (4,038)          | (38)             |
| Cash dividends paid   | (1,414)          | (1,408)          |
| Proceeds from exercise of stock options   | 172              | 45               |
| Net cash provided by (used in) financing activities                               | <u>8,782</u>     | <u>(1,610)</u>   |
| Net Increase in Cash and Cash Equivalents   | 21,131           | 12,647           |
| Cash and Cash Equivalents at Beginning of Period                                  | <u>18,514</u>    | <u>23,943</u>    |
| Cash and Cash Equivalents at End of Period  | <u>\$ 39,645</u> | <u>\$ 36,590</u> |

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



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

***Note 1 – Basis of Presentation***

The 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 March 31, 2011; the consolidated statements of income for the three months ended March 31, 2011 and 2010; the consolidated statements of changes in shareholders’ equity for the three months ended March 31, 2011 and 2010; and the consolidated statements of cash flows for the three months ended March 31, 2011 and 2010. Operating results for the three month periods ended March 31, 2011 are not necessarily indicative of the results that may occur for the year ending December 31, 2011. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company’s Form 10-K for the year ended December 31, 2010.

***Note 2 – Recent Accounting Pronouncements***

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

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

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

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

The Securities Exchange Commission ("SEC") has issued Final Rule No. 33-9002, "Interactive Data to Improve Financial Reporting", which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. generally accepted accounting principles ("GAAP") were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011.

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

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

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

**Note 3 – Securities**

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

|  |    | <b>March 31, 2011</b>     |                             |                              |                                 |
|--|----|---------------------------|-----------------------------|------------------------------|---------------------------------|
| (in thousands)                             |    | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
| <b>Securities available for sale:</b>      |    |                           |                             |                              |                                 |
| Federal agencies & GSE                     | \$ | 38,065                    | \$ 539                      | \$ 43                        | \$ 38,561                       |
| Mortgage-backed & CMO's                    |    | 56,412                    | 1,145                       | 228                          | 57,329                          |
| State and municipal                        |    | 126,794                   | 2,170                       | 804                          | 128,160                         |
| Corporate                                  |    | 1,977                     | 144                         | -                            | 2,121                           |
| <b>Total securities available for sale</b> |    | <b>223,248</b>            | <b>3,998</b>                | <b>1,075</b>                 | <b>226,171</b>                  |
| <b>Securities held to maturity:</b>        |    |                           |                             |                              |                                 |
| State and municipal                        |    | 3,146                     | 90                          | -                            | 3,236                           |
| <b>Total securities held to maturity</b>   |    | <b>3,146</b>              | <b>90</b>                   | <b>-</b>                     | <b>3,236</b>                    |
| <b>Total Securities</b>                    |    | <b>226,394</b>            | <b>\$ 4,088</b>             | <b>\$ 1,075</b>              | <b>\$ 229,407</b>               |
|  |    | <b>December 31, 2010</b>  |                             |                              |                                 |
| (in thousands)                             |    | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
| <b>Securities available for sale:</b>      |    |                           |                             |                              |                                 |
| Federal agencies & GSE                     | \$ | 57,292                    | \$ 785                      | \$ -                         | \$ 58,077                       |
| Mortgage-backed & CMO's                    |    | 62,128                    | 1,273                       | 419                          | 62,982                          |
| State and municipal                        |    | 104,937                   | 1,582                       | 1,421                        | 105,098                         |
| Corporate                                  |    | 1,974                     | 164                         | -                            | 2,138                           |
| <b>Total securities available for sale</b> |    | <b>226,331</b>            | <b>3,804</b>                | <b>1,840</b>                 | <b>228,295</b>                  |
| <b>Securities held to maturity:</b>        |    |                           |                             |                              |                                 |
| State and municipal                        |    | 3,334                     | 106                         | -                            | 3,440                           |
| <b>Total securities held to maturity</b>   |    | <b>3,334</b>              | <b>106</b>                  | <b>-</b>                     | <b>3,440</b>                    |
| <b>Total securities</b>                    |    | <b>\$ 229,665</b>         | <b>\$ 3,910</b>             | <b>\$ 1,840</b>              | <b>\$ 231,735</b>               |

**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 March 31, 2011. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

Available for sale and held to maturity securities that have been in a continuous unrealized loss position are as follows:

| (in thousands)      | <b>Total</b>                        |                            | <b>Less than 12 Months</b>          |                            | <b>12 Months or More</b>            |                            |
|---------------------|-------------------------------------|----------------------------|-------------------------------------|----------------------------|-------------------------------------|----------------------------|
|                     | <b>Estimated<br/>Fair<br/>Value</b> | <b>Unrealized<br/>Loss</b> | <b>Estimated<br/>Fair<br/>Value</b> | <b>Unrealized<br/>Loss</b> | <b>Estimated<br/>Fair<br/>Value</b> | <b>Unrealized<br/>Loss</b> |
| GSE debt securities | \$ 6,295                            | \$ 43                      | \$ 6,295                            | \$ 43                      | \$ -                                | \$ -                       |
| Mortgage-backed     | 17,557                              | 154                        | 17,557                              | 154                        | -                                   | -                          |
| Private label CMO's | 1,645                               | 74                         | 990                                 | 3                          | 655                                 | 71                         |
| State and municipal | 44,722                              | 804                        | 44,722                              | 804                        | -                                   | -                          |
| <b>Total</b>        | <b>\$ 70,219</b>                    | <b>\$ 1,075</b>            | <b>\$ 69,564</b>                    | <b>\$ 1,004</b>            | <b>\$ 655</b>                       | <b>\$ 71</b>               |

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*GSE debt securities.* The unrealized losses on the five investments in GSEs (“government sponsored entities”) 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 basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2011.

*GSE residential mortgage-backed securities.* The unrealized losses on the Company's investment in 12 GSE mortgage-backed securities were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2011.

*Private-Label Residential Mortgage-Backed Securities:* The unrealized losses associated with three private residential collateralized mortgage obligations (“CMOs”) 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. One variable rate CMO was downgraded to CCC status by Standard and Poor's in the first quarter of 2010. The Company engaged an independent advisory firm to review collateral. Based upon such review, the Company took an other-than-temporary impairment charge of \$31,000 in the first quarter of 2010. Based upon management's assessment of the expected credit losses of the securities given the performance of the underlying collateral compared to the credit enhancement, the Company expects to recover the remaining amortized cost basis of these securities.

*State and municipal securities:* The unrealized losses on the 55 investments in state and municipal securities were caused by interest rate increases, which were substantial in the municipal bond market during the fourth quarter of 2010 and only somewhat mitigated during the first quarter of 2011. 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 March 31, 2011.

The Company's investment in Federal Home Loan Bank of Atlanta (“FHLB”) stock totaled \$2,512,000 at March 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLB's or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at March 31, 2011 and no impairment has been recognized. FHLB stock is shown in restricted stock on the balance sheet and is not a part of the available for sale securities portfolio.

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

|                     | <b>Total</b>                |                        | <b>Less than 12 Months</b>  |                        | <b>12 Months or More</b>    |                        |
|---------------------|-----------------------------|------------------------|-----------------------------|------------------------|-----------------------------|------------------------|
|                     | <b>Estimated Fair Value</b> | <b>Unrealized Loss</b> | <b>Estimated Fair Value</b> | <b>Unrealized Loss</b> | <b>Estimated Fair Value</b> | <b>Unrealized Loss</b> |
| (in thousands)      |                             |                        |                             |                        |                             |                        |
| Mortgage-backed     | \$ 22,106                   | \$ 216                 | \$ 22,106                   | \$ 216                 | \$ -                        | \$ -                   |
| Private label CMO's | 1,583                       | 203                    | 1,031                       | 18                     | 552                         | 185                    |
| State and municipal | 46,532                      | 1,421                  | 46,532                      | 1,421                  | -                           | -                      |
| Total               | \$ 70,221                   | \$ 1,840               | \$ 69,669                   | \$ 1,655               | \$ 552                      | \$ 185                 |

*Other-Than-Temporary-Impaired Securities*

Other than the private label CMO discussed above, no other securities have been considered other than temporarily impaired as of March 31, 2011 and December 31, 2010.

**Note 4 - Loans**

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

| (in thousands)                    | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-----------------------------------|---------------------------|------------------------------|
| Commercial                        | \$ 84,702                 | \$ 85,051                    |
| Commercial real estate:           |                           |                              |
| Construction and land development | 36,516                    | 37,168                       |
| Commercial real estate            | 207,502                   | 210,393                      |
| Residential real estate:          |                           |                              |
| Residential                       | 118,603                   | 119,398                      |
| Home equity                       | 61,674                    | 61,064                       |
| Consumer                          | 7,632                     | 7,707                        |
| Total loans                       | <u>\$ 516,629</u>         | <u>\$ 520,781</u>            |

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

| (in thousands)  | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|---------------------------|------------------------------|
| Impaired loans with a valuation allowance   | \$ -                      | \$ -                         |
| Impaired loans without a valuation allowance  | 1,396                     | 560                          |
| Total impaired loans  | <u>\$ 1,396</u>           | <u>\$ 560</u>                |
| Allowance provided for impaired loans,<br>included in the allowance for loan losses | \$ -                      | \$ -                         |
| Nonaccrual loans excluded from the<br>impaired loan disclosure                      | \$ 2,021                  | \$ 2,037                     |
| (in thousands)  | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
| Average balance in impaired loans   | \$ 773                    | \$ 2,503                     |
| Interest income recognized on impaired loans  | \$ -                      | \$ 17                        |
| Interest income recognized on nonaccrual loans                                      | \$ -                      | \$ -                         |
| Loans past due 90 days and still accruing interest                                  | \$ -                      | \$ -                         |

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

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

At March 31, 2011

| (in thousands)                    | <u>30- 59 Days<br/>Past Due</u> | <u>60-89 Days<br/>Past Due</u> | <u>90 Days +<br/>Past Due<br/>and Still<br/>Accruing</u> | <u>Non-<br/>Accrual<br/>Loans</u> | <u>Total<br/>Past<br/>Due</u> | <u>Current</u>    | <u>Total<br/>Loans</u> |
|-----------------------------------|---------------------------------|--------------------------------|--|-----------------------------------|-------------------------------|-------------------|------------------------|
| Commercial                        | \$ 5                            | \$ -                           | \$ -   | \$ 351                            | \$ 356                        | \$ 84,346         | \$ 84,702              |
| Commercial real estate:           |                                 |                                |  |                                   |                               |                   |                        |
| Construction and land development | 1                               | 132                            | -  | 780                               | 913                           | 35,603            | 36,516                 |
| Commercial real estate            | 476                             | -                              | -  | 1,005                             | 1,481                         | 206,021           | 207,502                |
| Residential:                      |                                 |                                |  |                                   |                               |                   |                        |
| Residential                       | 990                             | 579                            | -  | 1,139                             | 2,708                         | 115,895           | 118,603                |
| Home equity                       | 89                              | 89                             | -  | 92                                | 270                           | 61,404            | 61,674                 |
| Consumer:                         |                                 |                                |  |                                   |                               |                   |                        |
| Consumer                          | 17                              | 12                             | -  | 50                                | 79                            | 7,553             | 7,632                  |
| Total                             | <u>\$ 1,578</u>                 | <u>\$ 812</u>                  | <u>\$ -</u>  | <u>\$ 3,417</u>                   | <u>\$ 5,807</u>               | <u>\$ 510,822</u> | <u>\$ 516,629</u>      |

At December 31, 2010

| (in thousands)                    | <u>30- 59 Days<br/>Past Due</u> | <u>60-89 Days<br/>Past Due</u> | <u>90 Days +<br/>Past due<br/>and Still<br/>Accruing</u> | <u>Non-<br/>Accrual<br/>Loans</u> | <u>Total<br/>Past<br/>Due</u> | <u>Current</u>    | <u>Total<br/>Loans</u> |
|-----------------------------------|---------------------------------|--------------------------------|--|-----------------------------------|-------------------------------|-------------------|------------------------|
| Commercial                        | \$ -                            | \$ 46                          | \$ -   | \$ 401                            | \$ 447                        | \$ 84,604         | \$ 85,051              |
| Commercial real estate:           |                                 |                                |  |                                   |                               |                   |                        |
| Construction and land development | -                               | 40                             | -  | 59                                | 99                            | 37,069            | 37,168                 |
| Commercial real estate            | 572                             | 175                            | -  | 614                               | 1,361                         | 209,032           | 210,393                |
| Residential:                      |                                 |                                |  |                                   |                               |                   |                        |
| Residential                       | 742                             | 704                            | -  | 1,419                             | 2,865                         | 116,533           | 119,398                |
| Home equity                       | 15                              | 23                             | -  | 97                                | 135                           | 60,929            | 61,064                 |
| Consumer:                         |                                 |                                |  |                                   |                               |                   |                        |
| Consumer                          | 8                               | 72                             | -  | 7                                 | 87                            | 7,620             | 7,707                  |
| Total                             | <u>\$ 1,337</u>                 | <u>\$ 1,060</u>                | <u>\$ -</u>  | <u>\$ 2,597</u>                   | <u>\$ 4,994</u>               | <u>\$ 515,787</u> | <u>\$ 520,781</u>      |

The following table presents the Company's impaired loan balances by portfolio segment at March 31, 2011.

| (in thousands)                      | <u>Recorded<br/>Investment</u> | <u>Unpaid<br/>Principal<br/>Balance</u> | <u>Related<br/>Allowance</u> | <u>Average<br/>Recorded<br/>Investment</u> | <u>Interest<br/>Income<br/>Recognized</u> |
|-------------------------------------|--------------------------------|---|------------------------------|--|---|
| With no related allowance recorded: |                                |   |                              |  |   |
| Commercial                          | \$ 144                         | \$ 149                                  | \$ -                         | \$ 144                                     | \$ -                                      |
| Commercial real estate              | 952                            | 952                                     | -                            | 318  | -   |
| Residential                         | 300                            | 342                                     | -                            | 311  | -   |
| With an related allowance recorded: |                                |   |                              |  |   |
| Commercial                          | -                              | -                                       | -                            | -  | -   |
| Commercial real estate              | -                              | -                                       | -                            | -  | -   |
| Residential                         | -                              | -                                       | -                            | -  | -   |
| Total:                              |                                |   |                              |  |   |
| Commercial                          | \$ 144                         | \$ 149                                  | \$ -                         | \$ 144                                     | \$ -                                      |
| Commercial real estate              | 952                            | 952                                     | -                            | 318  | -   |
| Residential                         | 300                            | 342                                     | -                            | 311  | -   |

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

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

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

**Credit Quality Indicators**  
As of March 31, 2011  
(in thousands)

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

|                 | <u>Commercial</u> | <u>Commercial Real Estate Construction</u> | <u>Commercial Real Estate Other</u> | <u>Residential</u> | <u>Home Equity</u> |
|-----------------|-------------------|--|-------------------------------------|--------------------|--------------------|
| Pass            | \$ 82,975         | \$ 31,420                                  | \$ 196,218                          | \$ 104,890         | \$ 60,130          |
| Special Mention | 1,149             | 1,602                                      | 6,448                               | 9,890              | 1,162              |
| Substandard     | 578               | 3,494                                      | 4,836                               | 3,823              | 382                |
| Doubtful        | -                 | -  | -                                   | -                  | -                  |
| Total           | <u>\$ 84,702</u>  | <u>\$ 36,516</u>                           | <u>\$ 207,502</u>                   | <u>\$ 118,603</u>  | <u>\$ 61,674</u>   |

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

|               | <u>Consumer</u> |
|---------------|-----------------|
| Performing    | \$ 7,366        |
| Nonperforming | 266             |
| Total         | <u>\$ 7,632</u> |

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

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

|                 | <u>Commercial</u> | <u>Commercial<br/>Real Estate<br/>Construction</u> | <u>Commercial<br/>Real Estate<br/>Other</u> | <u>Residential</u> | <u>Home<br/>Equity</u> |
|-----------------|-------------------|--|---|--------------------|------------------------|
| Pass            | \$ 83,693         | \$ 31,868  | \$ 196,668                                  | \$ 107,351         | \$ 59,604              |
| Special Mention | 844               | 1,669  | 8,387                                       | 8,350              | 1,150                  |
| Substandard     | 514               | 3,631  | 5,338                                       | 3,697              | 310                    |
| Doubtful        | -                 | -  | -   | -                  | -                      |
| <b>Total</b>    | <b>\$ 85,051</b>  | <b>\$ 37,168</b>                                   | <b>\$ 210,393</b>                           | <b>\$ 119,398</b>  | <b>\$ 61,064</b>       |

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

|               | <u>Consumer</u> |
|---------------|-----------------|
| Performing    | \$ 7,423        |
| Nonperforming | 284             |
| <b>Total</b>  | <b>\$ 7,707</b> |

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

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

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

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

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

Other real estate was \$3,532,000 at March 31, 2011 and \$3,716,000 December 31, 2010.



**Note 5 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments**

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for the three months ended March 31, 2011 and 2010, and for the year ended December 31, 2010, are presented below:

| (in thousands)                                  | Three Months Ended<br>March 31,<br>2011 | Year<br>Ended<br>December 31,<br>2010 | Three Months Ended<br>March 31,<br>2010 |
|---|---|---------------------------------------|---|
| <b>Allowance for Loan Losses</b>                |   |                                       |   |
| Balance, beginning of period                    | \$ 8,420                                | \$ 8,166                              | \$ 8,166                                |
| Provision for loan losses                       | 337                                     | 1,490                                 | 285                                     |
| Charge-offs                                     | (571)                                   | (1,531)                               | (427)                                   |
| Recoveries                                      | 71                                      | 295                                   | 88                                      |
| Balance, end of period                          | <u>\$ 8,257</u>                         | <u>\$ 8,420</u>                       | <u>\$ 8,112</u>                         |
| <b>Reserve for unfunded lending commitments</b> |   |                                       |   |
| Balance, beginning of period                    | \$ 218                                  | \$ 260                                | \$ 260                                  |
| Provision for unfunded commitments              | 6                                       | (42)                                  | (24)                                    |
| Charge-offs                                     | -                                       | -                                     | -                                       |
| Balance, end of period                          | <u>\$ 224</u>                           | <u>\$ 218</u>                         | <u>\$ 236</u>                           |

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

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

(in thousands)

|   | <u>Commercial</u> | <u>Commercial<br/>Real Estate</u> | <u>Residential<br/>Real Estate</u> | <u>Consumer</u> | <u>Total</u>    |
|---|-------------------|-----------------------------------|------------------------------------|-----------------|-----------------|
| <b><u>Allowance for Loan Losses</u></b> |                   |                                   |                                    |                 |                 |
| Balance as of December 31, 2010         | \$ 751            | \$ 4,623                          | \$ 2,929                           | \$ 117          | \$ 8,420        |
| Charge-offs                             | (106)             | (307)                             | (134)                              | (24)            | (571)           |
| Recoveries                              | 27                | 6                                 | 16                                 | 22              | 71              |
| Provision                               | 150               | 63                                | 113                                | 11              | 337             |
| Balance as of March 31, 2011            | <u>\$ 822</u>     | <u>\$ 4,385</u>                   | <u>\$ 2,924</u>                    | <u>\$ 126</u>   | <u>\$ 8,257</u> |

Balances at March 31, 2011:

|   |               |                 |                 |               |                 |
|---|---------------|-----------------|-----------------|---------------|-----------------|
| <b><u>Allowance for Loan Losses</u></b> |               |                 |                 |               |                 |
| Individually evaluated for impairment   | \$ -          | \$ -            | \$ -            | \$ -          | \$ -            |
| Collectively evaluated for impairment   | 822           | 4,385           | 2,924           | 126           | 8,257           |
| Total                                   | <u>\$ 822</u> | <u>\$ 4,385</u> | <u>\$ 2,924</u> | <u>\$ 126</u> | <u>\$ 8,257</u> |

**Loans**

|                                       |                  |                   |                   |                 |                   |
|---------------------------------------|------------------|-------------------|-------------------|-----------------|-------------------|
| Individually evaluated for impairment | \$ 144           | \$ 952            | \$ 300            |                 | \$ 1,396          |
| Collectively evaluated for impairment | 84,558           | 243,066           | 179,977           | 7,632           | 515,233           |
| Total                                 | <u>\$ 84,702</u> | <u>\$ 244,018</u> | <u>\$ 180,277</u> | <u>\$ 7,632</u> | <u>\$ 516,629</u> |

Balances at December 31, 2010:

|   |               |                 |                 |               |                 |
|---|---------------|-----------------|-----------------|---------------|-----------------|
| <b><u>Allowance for Loan Losses</u></b> |               |                 |                 |               |                 |
| Individually evaluated for impairment   | \$ -          | \$ -            | \$ -            | \$ -          | \$ -            |
| Collectively evaluated for impairment   | 751           | 4,623           | 2,929           | 117           | 8,420           |
| Total                                   | <u>\$ 751</u> | <u>\$ 4,623</u> | <u>\$ 2,929</u> | <u>\$ 117</u> | <u>\$ 8,420</u> |

**Loans**

|                                       |                  |                   |                   |                 |                   |
|---------------------------------------|------------------|-------------------|-------------------|-----------------|-------------------|
| Individually evaluated for impairment | \$ 231           | \$ 329            | \$ -              | \$ -            | \$ 560            |
| Collectively evaluated for impairment | 84,820           | 247,232           | 180,462           | 7,707           | 520,221           |
| Total                                 | <u>\$ 85,051</u> | <u>\$ 247,561</u> | <u>\$ 180,462</u> | <u>\$ 7,707</u> | <u>\$ 520,781</u> |

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

In January 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (Accounting Standards Codification (“ASC”) 805), “Goodwill and Other Intangible Assets”. Accordingly, goodwill is no longer subject to amortization, but is subject to at least an annual assessment for impairment by applying a fair value test. A fair value-based test was performed during the third quarter of 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 March 31, 2011, are as follows (in thousands):

|                                     |                  |
|-------------------------------------|------------------|
| Balance as of December 31, 2010     | \$ 22,468        |
| Goodwill recorded during the period | -                |
| Impairment losses                   | -                |
| Balance as of March 31, 2011        | <u>\$ 22,468</u> |

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 March 31, 2011 was \$1,226,000.

**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. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following as of March 31, 2011 and December 31, 2010 (in thousands):

|                                | <u>March 31,</u><br><u>2011</u> | <u>December 31,</u><br><u>2010</u> |
|--------------------------------|---------------------------------|------------------------------------|
| Customer repurchase agreements | \$ 43,871                       | \$ 47,084                          |
| FHLB overnight borrowings      | -                               | 6,110                              |
|                                | <u>\$ 43,871</u>                | <u>\$ 53,194</u>                   |

**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 March 31, 2011, \$88,818,000 in 1-4 family residential mortgage loans and \$59,751,000 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 March 31, 2011 and December 31, 2010 (in thousands):

| <u>March 31, 2011</u> |                   |                             | <u>December 31, 2010</u> |                   |                             |
|-----------------------|-------------------|-----------------------------|--------------------------|-------------------|-----------------------------|
| Due by                | Advance<br>Amount | Weighted<br>Average<br>Rate | Due by                   | Advance<br>Amount | Weighted<br>Average<br>Rate |
| April 2011            | \$ 4,000          | 2.93                        | March 2011               | \$ 8,000          | 2.93                        |
| April 2014            | 450               | 3.78                        | April 2014               | 488               | 3.78                        |
|                       | <u>\$ 4,450</u>   | 3.02%                       |                          | <u>\$ 8,488</u>   | 2.97%                       |

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the States of Virginia and North Carolina. At March 31, 2011, the Company's public deposits totaled \$74,306,000. 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 or agency bonds or letters of credit from the FHLB. At March 31, 2011, the Company had \$40 million in letters of credit with the FHLB outstanding to provide collateral for such deposits.

**Note 9 – Trust Preferred Capital Notes**

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

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

**Note 10 – Stock Based Compensation***Stock Options*

A summary of stock option transactions for the three months ended March 31, 2011, is as follows:

|                                  | <u>Option<br/>Shares</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> | <u>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Term</u> | <u>Average<br/>Intrinsic<br/>Value<br/>(\$000)</u> |
|----------------------------------|--------------------------|--|--|--|
| Outstanding at December 31, 2010 | 159,499                  | \$ 21.48   |  |  |
| Granted                          | -                        | -  |  |  |
| Exercised                        | (10,510)                 | 16.44  |  |  |
| Forfeited                        | (450)                    | 25.44  |  |  |
| Outstanding at March 31, 2011    | <u>148,539</u>           | \$ 21.82   | 4.5  | \$ 328   |
| Exercisable at March 31, 2011    | 133,289                  | \$ 22.39   | 4.2  | \$ 242   |

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 March 31, 2011, there was \$47,000 in total unrecognized compensation expense related to nonvested stock option grants.

*Restricted Stock*

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

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

Nonvested restricted stock for the three months ended March 31, 2011 is summarized in the following table.

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

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As of March 31, 2011, there was \$325,000 of total unrecognized compensation cost related to nonvested restricted stock granted under the plan. This cost is expected to be recognized over the next 21 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. In 2011, monthly meeting fees could also be received as \$400 per month in cash or \$500 in immediately vested, but restricted stock. For the first quarter 2011, ten of thirteen directors elected to receive stock in lieu of cash for their retainer and meeting fees. Only outside directors receive board fees. The Company issued 2,358 shares and recognized share based compensation expense of \$50,000 during the quarter.

**Note 11 – Earnings Per Share**

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

|   | Three Months Ended<br>March 31, |                  |           |                  |
|---|---------------------------------|------------------|-----------|------------------|
|   | 2011                            |                  | 2010      |                  |
|   | Shares                          | Per Share Amount | Shares    | Per Share Amount |
| Basic   | 6,143,602                       | \$ .29           | 6,119,415 | \$ .36           |
| Effect of dilutive securities - stock options | 9,136                           | -                | 4,891     | -                |
| Diluted                                       | 6,152,738                       | \$ .29           | 6,124,306 | \$ .36           |

Stock options on common stock which were not included in computing diluted earnings per share for the three month periods ended March 31, 2011 and 2010, because their effects were antidilutive, averaged 82,177 and 96,091, respectively.

**Note 12 – Employee Benefit Plans**

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

| Components of Net Periodic Benefit Cost<br>(in thousands) | Three Months Ended<br>March 31, |       |
|---|---------------------------------|-------|
|   | 2011                            | 2010  |
| Service cost  | \$ 27                           | \$ 23 |
| Interest cost   | 101                             | 117   |
| Expected return on plan assets                            | (131)                           | (135) |
| Recognized net actuarial loss                             | 40                              | 57    |
| Net periodic benefit cost                                 | \$ 37                           | \$ 62 |

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

**Note 13 – Segment and Related Information**

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

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

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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 three month periods ended March 31, 2011 and 2010, is shown in the following table.

| (in thousands)                       | <b>Three Months Ended March 31, 2011</b> |  |              |                                      |              |
|--------------------------------------|--|--|--------------|--------------------------------------|--------------|
|                                      | <b>Community<br/>Banking</b>             | <b>Trust and<br/>Investment<br/>Services</b> | <b>Other</b> | <b>Intersegment<br/>Eliminations</b> | <b>Total</b> |
| Interest income                      | \$ 8,661                                 | \$ -   | \$ 20        | \$ (20)                              | \$ 8,661     |
| Interest expense                     | 1,733                                    | -  | 343          | (20)                                 | 2,056        |
| Noninterest income                   | 971                                      | 968  | 10           | -                                    | 1,949        |
| Operating income before income taxes | 2,455                                    | 595  | (590)        | -                                    | 2,460        |
| Depreciation and amortization        | 393                                      | 5  | -            | -                                    | 398          |
| Total assets                         | 840,576                                  | -  | 662          | -                                    | 841,238      |
| Capital expenditures                 | 103                                      | -  | -            | -                                    | 103          |

| (in thousands)                       | <b>Three Months Ended March 31, 2010</b> |  |              |                                      |              |
|--------------------------------------|--|--|--------------|--------------------------------------|--------------|
|                                      | <b>Community<br/>Banking</b>             | <b>Trust and<br/>Investment<br/>Services</b> | <b>Other</b> | <b>Intersegment<br/>Eliminations</b> | <b>Total</b> |
| Interest income                      | \$ 9,051                                 | \$ -   | \$ 37        | \$ (37)                              | \$ 9,051     |
| Interest expense                     | 1,841                                    | -  | 343          | (37)                                 | 2,147        |
| Noninterest income                   | 1,079                                    | 832  | 10           | -                                    | 1,921        |
| Operating income before income taxes | 2,884                                    | 548  | (389)        | -                                    | 3,043        |
| Depreciation and amortization        | 414                                      | 4  | -            | -                                    | 418          |
| Total assets                         | 809,989                                  | -  | 665          | -                                    | 810,654      |
| Capital expenditures                 | 272                                      | 1  | -            | -                                    | 273          |

#### **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.

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

Fair Value Hierarchy

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

- Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.
- Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
- Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

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

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

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2011 (in thousands):

| Description                    | Balance as of<br>March 31,<br>2011 | Fair Value Measurements at March 31, 2011 Using               |  |                                       |
|--------------------------------|------------------------------------|---|--|---------------------------------------|
|                                |                                    | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|                                |                                    | Level 1   | Level 2                                      | Level 3                               |
| Assets:                        |                                    |   |  |                                       |
| Securities available for sale: |                                    |   |  |                                       |
| Federal agencies and GSE       | \$ 38,561                          | \$ -  | \$ 38,561                                    | \$ -                                  |
| Mortgage-backed and CMO's      | 57,329                             | -   | 56,840                                       | 489                                   |
| State and municipal            | 128,160                            | -   | 128,160                                      | -                                     |
| Corporate                      | 2,121                              | -   | 2,121  | -                                     |
| Total                          | <u>\$ 226,171</u>                  | <u>\$ -</u>   | <u>\$ 225,682</u>                            | <u>\$ 489</u>                         |

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

|   | Fair Value Measurements Using Significant Unobservable Inputs (Level 3) |            |                                  |   |                                 | Balances as of<br>March 31,<br>2011 |
|---|---|------------|----------------------------------|---|---------------------------------|-------------------------------------|
|   | Total Realized / Unrealized Gains<br>(Losses) Included in               |            |                                  |   |                                 |                                     |
|   | Balances as of<br>January 1, 2011                                       | Net Income | Other<br>Comprehensive<br>Income | Purchases,<br>Sales, Issuances<br>and Settlements,<br>Net | Transfer In<br>(Out) of Level 3 |                                     |
| Securities available for sale                             |   |            |                                  |   |                                 |                                     |
| Private label Collateralized Mortgage<br>Obligation (ARM) | \$ 388  | \$ -       | \$ 119                           | \$ (18)   | \$ -                            | \$ 489                              |
| Total assets  | \$ 388  | \$ -       | \$ 119                           | \$ (18)   | \$ -                            | \$ 489                              |

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 March 31, 2011. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

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



Other real estate owned: Certain assets such as other real estate owned (“OREO”) are measured at fair value less cost to sell. 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):

| <u>Description</u>                         | <u>Balance as of<br/>March 31,<br/>2011</u> | <u>Fair Value Measurements at March 31, 2011 Using</u>                              |  |  |
|--|---|---|--|--|
|  |   | <u>Quoted Prices<br/>in Active<br/>Markets for<br/>Identical Assets<br/>Level 1</u> | <u>Significant<br/>Other<br/>Observable<br/>Inputs<br/>Level 2</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>Level 3</u> |
|  |   | Level 1   | Level 2  | Level 3  |
| Assets                                     |   |   |  |  |
| Loans held for sale                        | 1,309                                       | -   | 1,309  | -  |
| Impaired loans, net of valuation allowance | 1,396                                       | -   | 1,396  | -  |
| Other real estate owned                    | 3,532                                       | -   | 3,532  | -  |

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

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

| (in thousands)                | <u>March 31, 2011</u>      |                                     | <u>December 31, 2010</u>   |                                     |
|-------------------------------|----------------------------|-------------------------------------|----------------------------|-------------------------------------|
|                               | <u>Carrying<br/>Amount</u> | <u>Estimated<br/>Fair<br/>Value</u> | <u>Carrying<br/>Amount</u> | <u>Estimated<br/>Fair<br/>Value</u> |
| Financial assets:             |                            |                                     |                            |                                     |
| Cash and due from banks       | \$ 39,645                  | \$ 39,645                           | \$ 18,514                  | \$ 18,514                           |
| Securities available for sale | 226,171                    | 226,171                             | 228,295                    | 228,295                             |
| Securities held to maturity   | 3,146                      | 3,236                               | 3,334                      | 3,440                               |
| Loans held for sale           | 1,309                      | 1,309                               | 3,135                      | 3,135                               |
| Loans, net of allowance       | 508,372                    | 514,000                             | 512,361                    | 519,338                             |
| Accrued interest receivable   | 3,384                      | 3,384                               | 3,704                      | 3,704                               |
| Financial liabilities:        |                            |                                     |                            |                                     |
| Deposits                      | \$ 663,483                 | \$ 665,769                          | \$ 640,098                 | \$ 642,705                          |
| Repurchase agreements         | 43,871                     | 43,871                              | 47,084                     | 47,084                              |
| Other borrowings              | 4,450                      | 4,457                               | 14,598                     | 14,600                              |
| Trust preferred capital notes | 20,619                     | 20,516                              | 20,619                     | 20,531                              |
| Accrued interest payable      | 770                        | 770                                 | 831                        | 831                                 |

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

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

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

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

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

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

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

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

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

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

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

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

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

**Note 15 – Supplemental Cash Flow Information**

|   | Three Months Ended |                  |
|---|--------------------|------------------|
|   | March 31,          |                  |
|   | 2011               | 2010             |
| Supplemental Schedule of Cash and Cash Equivalents:     |                    |                  |
| Cash and due from banks                                 | \$ 14,248          | \$ 11,059        |
| Interest-bearing deposits in other banks                | 25,397             | 25,531           |
|   | <u>\$ 39,645</u>   | <u>\$ 36,590</u> |
| Supplemental Disclosure of Cash Flow Information:       |                    |                  |
| Cash paid for:  |                    |                  |
| Interest on deposits and borrowed funds                 | \$ 2,116           | \$ 2,198         |
| Income taxes  | -                  | 4                |
| Noncash investing and financing activities:             |                    |                  |
| Transfer of loans to other real estate owned            | 178                | 526              |
| Unrealized gain (loss) on securities available for sale | 959                | (151)            |

**Note 16 – Proposed Merger**

On December 16, 2010, American National Bankshares Inc. announced that it had entered into an Agreement and Plan of Reorganization, dated December 15, 2010, with MidCarolina Financial Corporation (“MidCarolina”), pursuant to which it will acquire MidCarolina in a business combination transaction. MidCarolina is headquartered in Burlington, North Carolina and the transaction will expand the Company’s footprint in North Carolina, adding eight branches in Alamance and Guilford Counties. The Company expects that it will have approximately \$1.4 billion in assets upon completion of the merger.

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

Subject to customary closing conditions, including regulatory and shareholder approvals, the Company expects the merger to close in early July 2011. Following completion of the Merger, MidCarolina’s subsidiary bank, MidCarolina Bank, will be merged into American National Bank and Trust Company.

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

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

### **Forward-Looking Statements**

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

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

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

### **Reclassification**

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

### **Critical Accounting Policies**

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting 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 2010 Annual Report on Form 10-K.

The financial information contained within the Company's financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset, or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method.

*Allowance for Loan Losses and Reserve for Unfunded Loan Commitments*

The allowance for loan losses is an estimate of the losses inherent in the loan portfolio at the balance sheet date. The allowance is based on two basic principles of accounting: Financial Accounting Standards Board (“FASB”) Topic 450-25 *Contingencies - Recognition* which requires that losses be accrued when they are probable of occurring and estimable and 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. With regard to commercial loans, the formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, and portfolio concentrations. In the formula allowance, the migrated historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. With regard to consumer loans, the allowance calculations are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. The formula allowance is calculated for a range of outcomes. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

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

*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, 2010 have occurred that would question the impairment of goodwill.

**Non-GAAP Presentations**

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

**Internet Access to Corporate Documents**

The Company provides access to its Securities and Exchange Commission (“SEC”) filings through a link on the Investors Relations page of the Company’s web site at [www.amnb.com](http://www.amnb.com). Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The information on the Company’s website is not incorporated into this report or any other filing the Company makes with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

**RESULTS OF OPERATIONS****Earnings Performance****Three months ended March 31, 2011 and 2010**

For the quarter ended March 31, 2011, the Company reported net income of \$1,778,000 compared to \$2,185,000 for the comparable quarter in 2010. The \$407,000 or 18.6% decrease in earnings was primarily due to:

- a \$299,000 decrease in net interest income, primarily related to a declining net interest margin and
- a \$260,000 increase in noninterest expenses, mostly related to \$309,000 in merger related expenses charged during the quarter.

**SUMMARY INCOME STATEMENT**  
(dollars in thousands)

| For the three months ended March 31, | 2011            | 2010            | \$ Change       | % Change      |
|--------------------------------------|-----------------|-----------------|-----------------|---------------|
| Interest income                      | \$ 8,661        | \$ 9,051        | \$ (390)        | -4.3%         |
| Interest expense                     | (2,056)         | (2,147)         | 91              | -4.2%         |
| Net interest income                  | 6,605           | 6,904           | (299)           | -4.3%         |
| Provision for loan losses            | (337)           | (285)           | (52)            | 18.2%         |
| Noninterest income                   | 1,949           | 1,921           | 28              | 1.5%          |
| Noninterest expense                  | (5,757)         | (5,497)         | (260)           | 4.7%          |
| Income tax expense                   | (682)           | (858)           | 176             | -20.5%        |
| Net income                           | <u>\$ 1,778</u> | <u>\$ 2,185</u> | <u>\$ (407)</u> | <u>-18.6%</u> |

**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 March 31, 2011 and 2010**

Net interest income on a taxable equivalent basis decreased \$170,000 or 2.4%, for the first quarter of 2011 compared to the same quarter of 2010. This decrease was due primarily to changes in yields on earning assets, as indicated by the Net Interest Income analysis later in this section.

For the first quarter of 2011 and 2010, the Company's yield on earnings assets was 4.74% compared to 5.07%. The cost of interest bearing liabilities was 1.35% compared to 1.45%. The interest rate spread was 3.39% compared to 3.62%. The net interest margin, on a fully taxable equivalent basis, was 3.66% compared to 3.89%. Yields and rates generally fell between periods.

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 March 31, 2011 and 2010. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

**Net Interest Income Analysis**  
 For the Three Months Ended March 31, 2011 and 2010  
 (in thousands, except rates)

|  | Average Balance |            | Interest<br>Income/Expense |          | Yield/Rate |       |
|--|-----------------|------------|----------------------------|----------|------------|-------|
|  | 2011            | 2010       | 2011                       | 2010     | 2011       | 2010  |
| <b>Loans:</b>                                  |                 |            |                            |          |            |       |
| Commercial                                     | \$ 77,925       | \$ 79,279  | \$ 880                     | \$ 953   | 4.58%      | 4.88% |
| Real estate                                    | 432,688         | 434,795    | 5,695                      | 6,095    | 5.26       | 5.61  |
| Consumer                                       | 7,505           | 6,773      | 136                        | 134      | 7.35       | 8.02  |
| Total loans                                    | 518,118         | 520,847    | 6,711                      | 7,182    | 5.19       | 5.53  |
| <b>Securities:</b>                             |                 |            |                            |          |            |       |
| Federal agencies & GSE                         | 43,345          | 65,751     | 323                        | 551      | 2.98       | 3.35  |
| Mortgage-backed & CMO's                        | 59,297          | 43,783     | 490                        | 501      | 3.31       | 4.58  |
| State and municipal                            | 117,916         | 67,538     | 1,408                      | 927      | 4.78       | 5.49  |
| Other  | 6,037           | 7,624      | 58                         | 69       | 3.84       | 3.62  |
| Total securities                               | 226,595         | 184,696    | 2,279                      | 2,048    | 4.02       | 4.44  |
| Deposits in other banks                        | 20,578          | 30,640     | 70                         | 91       | 1.38       | 1.20  |
| Total interest-earning assets                  | 765,291         | 736,183    | 9,060                      | 9,321    | 4.74       | 5.07  |
| Non-earning assets                             | 72,860          | 74,437     |                            |          |            |       |
| Total assets                                   | \$ 838,151      | \$ 810,620 |                            |          |            |       |
| <b>Deposits:</b>                               |                 |            |                            |          |            |       |
| Demand   | \$ 96,698       | \$ 97,062  | 18                         | 21       | 0.08       | 0.09  |
| Money market                                   | 63,125          | 80,809     | 83                         | 90       | 0.53       | 0.45  |
| Savings  | 62,505          | 62,801     | 21                         | 22       | 0.14       | 0.14  |
| Time   | 319,776         | 266,537    | 1,458                      | 1,502    | 1.85       | 2.29  |
| Total deposits                                 | 542,104         | 507,209    | 1,580                      | 1,635    | 1.18       | 1.31  |
| Customer repurchase agreements                 | 43,762          | 63,947     | 80                         | 105      | 0.74       | 0.67  |
| Other short-term borrowings                    | 136             | -          | 0                          | -        | 0.47       | -     |
| Long-term borrowings                           | 27,855          | 29,248     | 396                        | 407      | 5.69       | 5.57  |
| Total interest-bearing liabilities             | 613,857         | 600,404    | 2,056                      | 2,147    | 1.35       | 1.45  |
| Noninterest bearing demand deposits            | 110,818         | 98,876     |                            |          |            |       |
| Other liabilities                              | 4,252           | 4,004      |                            |          |            |       |
| Shareholders' equity                           | 109,224         | 107,336    |                            |          |            |       |
| Total liabilities and shareholders' equity     | \$ 838,151      | \$ 810,620 |                            |          |            |       |
| Interest rate spread                           |                 |            |                            |          | 3.39%      | 3.62% |
| Net interest margin                            |                 |            |                            |          | 3.66%      | 3.89% |
| Net interest income (taxable equivalent basis) |                 |            | 7,004                      | 7,174    |            |       |
| Less: Taxable equivalent adjustment            |                 |            | 399                        | 270      |            |       |
| Net interest income                            |                 |            | \$ 6,605                   | \$ 6,904 |            |       |

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

|                                | Three months ended March 31<br>2011 vs. 2010 |                           |         |
|--------------------------------|--|---------------------------|---------|
|                                | Increase<br>(Decrease)                       | Change<br>Attributable to |         |
|                                |  | Rate                      | Volume  |
| Interest income                |  |                           |         |
| Loans:                         |  |                           |         |
| Commercial                     | \$ (73)                                      | \$ (57)                   | \$ (16) |
| Real estate                    | (400)  | (371)                     | (29)    |
| Consumer                       | 2  | (12)                      | 14      |
| Total loans                    | (471)  | (440)                     | (31)    |
| Securities:                    |  |                           |         |
| Federal agencies               | (228)  | (56)                      | (172)   |
| Mortgage-backed                | (11)   | (161)                     | 150     |
| State and municipal            | 481  | (134)                     | 615     |
| Other securities               | (11)   | 4                         | (15)    |
| Total securities               | 231  | (347)                     | 578     |
| Deposits in other banks        | (21)   | 12                        | (33)    |
| Total interest income          | (261)  | (775)                     | 514     |
| Interest expense               |  |                           |         |
| Deposits:                      |  |                           |         |
| Demand                         | (3)  | (3)                       | -       |
| Money market                   | (7)  | 15                        | (22)    |
| Savings                        | (1)  | (1)                       | -       |
| Time                           | (44)   | (315)                     | 271     |
| Total deposits                 | (55)   | (304)                     | 249     |
| Customer repurchase agreements | (25)   | 11                        | (36)    |
| Other borrowings               | (11)   | 7                         | (18)    |
| Total interest expense         | (91)   | (286)                     | 195     |
| Net interest income            | \$ (170)                                     | \$ (489)                  | \$ 319  |

**Noninterest Income**

All comparisons discussed below are between the first quarter 2011 and the first quarter of 2010, unless otherwise noted.

Noninterest income increased to \$1,949,000 in 2011 from \$1,921,000 in 2010, a \$28,000 or 1.5% increase. The major factors impacting that change are discussed below.

Fees from the management of trusts, estates, and asset management accounts increased to \$928,000 in 2011 from \$812,000 in 2010, a \$116,000 or 14.3% increase. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large impact on income.

Service charges on deposit accounts decreased to \$421,000 in 2011 from \$479,000 in 2010, a \$58,000 or 12.1% decline. This reduction was primarily the result of lower returned check charges.

Other fees and commissions increased to \$316,000 in 2011 from \$278,000 in 2009, an increase of \$38,000 or 13.7% due primarily to increases VISA check card income.

Mortgage banking income decreased to \$147,000 in 2011 from \$246,000 in 2010, a decline of \$99,000 or 40.2%. This decline is directly related to declining volumes in mortgage demand.

Securities gains were \$1,000 for 2011 compared to a \$29,000 loss in 2010. Gains in the current period were related to calls prior to maturity of government agencies.

Other real estate losses were \$22,000 for 2011 compared to \$3,000 in 2010.



## **Noninterest Expense**

All comparisons discussed below are between the first quarter 2011 and the first quarter of 2010, unless otherwise noted.

Noninterest expense was \$5,757,000 for 2011 compared to \$5,497,000 for 2010, a \$260,000 or 4.7% increase. The major factors impacting that change are discussed below.

Salaries were \$2,485,000 for 2011 compared to \$2,398,000 for 2010, an \$87,000 or 3.6% increase. This is mostly the result of staffing increases in late 2010.

Employee benefits were \$541,000 for 2011 compared to \$640,000 for 2010, a \$99,000 or 15.5% decrease. This was due primarily to improved health insurance claims experience in the 2011 quarter.

Occupancy expense was \$699,000 for 2011 compared to \$779,000 for 2010, an \$80,000 or 10.3% decrease. This was mostly the result lower depreciation, repairs and maintenance costs.

Other expenses were \$1,558,000 for 2011 compared to \$1,224,000 for 2010, a \$334,000 or 27.3% increase. This was due almost entirely from \$309,000 in expenses related to the pending merger with MidCarolina Financial Corporation.

## **Income Taxes**

The effective tax rate for the first quarter of 2011 was 27.7% compared to 28.2% for the first quarter of 2010.

The effective tax rate is lower than the statutory rate of 35% 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. The effective tax rate is also impacted by the non-deductible portion of merger related expenses during the quarter, of approximately \$257,000.

## **Impact of Inflation and Changing Prices**

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

## **CHANGES IN FINANCIAL POSITION**

### **BALANCE SHEET ANALYSIS**

#### **Securities**

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

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The available for sale securities portfolio was \$226,171,000 at March 31, 2011 compared to \$228,295,000 at December 31, 2010, a \$2,124,000 or 0.93% decrease. The held to maturity securities portfolio was \$3,146,000 at March 31, 2011 compared to \$3,334,000 at December 31, 2010, a \$188,000 or 5.6% decrease.

At March 31, 2011, the available for sale portfolio had an estimated fair value of \$226,171,000 and an amortized cost of \$223,248,000, resulting in a net unrealized gain of \$2,923,000. At the same dates, the held to maturity portfolio had an estimated fair value of \$3,236,000 and an amortized cost of \$3,146,000, resulting in a net unrealized gain of \$90,000.

At March 31, 2011, mortgage-backed securities consisted principally of obligations of U.S. government sponsored enterprises. However, the portfolio has four private label CMOs (collateralized mortgage obligations) aggregating \$1,645,000 in fair value. One private label variable rate CMO had an amortized cost of \$546,000 and an estimated fair value of \$489,000; resulting in an estimated net unrealized loss of \$57,000. This bond was downgraded in the first quarter 2010 by Standard and Poor's to CCC status. After reviewing the security, management elected to take an other-than-temporary-impairment charge of \$31,000 against the bond in March 2010. The bond has been reviewed quarterly since then and no additional impairment charges have been required.

The Company is aware of the historically low current interest rate environment and has elected to maintain an investment 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 to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans decreased \$2,729,000, or 0.5% between first quarter 2011 and the first quarter 2010.

Loans were \$516,629,000 at March 31, 2011 compared to \$520,781,000 at December 31, 2010, a \$4,152,000 or 0.8% decrease. Approximately \$3.5 million of the decline represented a loan participation with MidCarolina Bank, in Burlington, NC, with whom the Bank anticipates a mid-year merger. In effect, loan volume was almost unchanged during the quarter.

Loans held for sale totaled \$3,146,000 at March 31, 2011, and \$3,334,000 at December 31, 2010, a \$188,000 or 5.6% decrease. The Bank has experienced and expects to continue seeing declining volumes in demand for secondary market mortgages.

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

| (in thousands)                    | March 31,<br>2011 | December<br>31,<br>2010 |
|-----------------------------------|-------------------|-------------------------|
| Commercial                        | \$ 84,702         | \$ 85,051               |
| Commercial real estate:           |                   |                         |
| Construction and land development | 36,516            | 37,168                  |
| Commercial real estate            | 207,502           | 210,393                 |
| Residential real estate:          |                   |                         |
| Residential                       | 118,603           | 119,398                 |
| Home equity                       | 61,674            | 61,064                  |
| Consumer                          | 7,632             | 7,707                   |
| Total loans                       | <u>\$ 516,629</u> | <u>\$ 520,781</u>       |

## Allowance for Loan Losses

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

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

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

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

The Company's allowance for loan losses has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates. With regard to commercial loans, the formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, and portfolio concentrations. In the formula allowance, the migrated historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. With regard to consumer loans, the allowance calculations for consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. The formula allowance is calculated for a range of outcomes. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

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

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

At March 31, 2011, the allowance for loan losses was \$8,257,000, compared to \$8,420,000 at December 31, 2010. The allowance for loan losses as a percentage of loans at each of those dates was 1.60% and 1.62%. During the 2011 quarter the allowance for loan losses decreased by \$163,000 or 1.9% and the loan portfolio contracted by \$4,152,000 or 0.8%. Management believes that the change in the allowance is appropriate in light of the decline in the size of the overall portfolio.

The provision for loan losses for the 2011 quarter was \$337,000 and the provision for 2010 was \$1,490,000.

Net loans charge-offs totaled \$500,000 for the 2011 period and \$1,236,000 in 2010. Net charge offs to average loans during the same periods totaled 0.39% and 0.24%, respectively.

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

**Summary of Loan Loss Experience**  
(in thousands)

|                                   | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-----------------------------------|---------------------------|------------------------------|
| Balance at beginning of period    | \$ 8,420                  | \$ 8,166                     |
| Allowance from acquisition        | -                         | -                            |
| Charge-offs:                      |                           |                              |
| Construction and land development | -                         | -                            |
| Commercial real estate            | 352                       | 666                          |
| Residential real estate           | 89                        | 310                          |
| Home equity                       | -                         | 135                          |
| Total real estate                 | 441                       | 1,111                        |
| Commercial and industrial         | 106                       | 306                          |
| Consumer                          | 24                        | 114                          |
| Total charge-offs                 | 571                       | 1,531                        |
| Recoveries:                       |                           |                              |
| Construction and land development | -                         | 147                          |
| Commercial real estate            | 5                         | 9                            |
| Residential real estate           | 16                        | 29                           |
| Home equity                       | 3                         | 2                            |
| Total real estate                 | 24                        | 187                          |
| Commercial and industrial         | 26                        | 32                           |
| Consumer                          | 21                        | 76                           |
| Total recoveries                  | 71                        | 295                          |
| Net charge-offs                   | 500                       | 1,236                        |
| Provision for loan losses         | 337                       | 1,490                        |
| Balance at end of period          | <u>\$ 8,257</u>           | <u>\$ 8,420</u>              |

Asset Quality Indicators

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

|  | <u>March 31,</u><br><u>2011</u> | <u>December 31,</u><br><u>2010</u> |
|--|---------------------------------|------------------------------------|
| Allowance to loans*                    | 1.60%                           | 1.62%                              |
| Net charge-offs to year-end allowance# | 24.22                           | 14.68                              |
| Net charge-offs to average loans#      | 0.39                            | 0.24                               |
| Nonperforming assets to total assets*  | 0.82                            | 0.76                               |
| Nonperforming loans to loans*          | 0.66                            | 0.50                               |
| Provision to net charge-offs           | 67.40                           | 120.52                             |
| Provision to average loans#            | 0.26                            | 0.29                               |
| Allowance to nonperforming loans*      | 241.64                          | 324.22                             |

\* - at quarter or year-end

# - annualized

Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming loans to total loans were 0.66% at March 31, 2011 compared to 0.50% at December 31, 2010.

Nonperforming assets include nonperforming loans and other real estate. Nonperforming assets represented 0.82% of total assets at March 31, 2011, up from 0.76% at December 31, 2010. Included in nonperforming assets, there were \$700,000 in troubled debt restructurings at March 31, 2011 and \$0 at December 31, 2010.

It is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The \$3,417,000 in nonaccrual loans shown on the following table includes \$1,396,000 in impaired loans. The remainder represent loans which were not deemed impaired. Based on the performance of these loans and existing circumstances, management did not believe loss was probable and did not classify these loans as impaired.

The following table presents the Company's nonperforming asset.

|   | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|---------------------------|------------------------------|
| <b>Nonperforming Assets</b><br>(in thousands) |                           |                              |
| Nonaccrual loans:                             |                           |                              |
| Real estate                                   | \$ 2,460                  | \$ 2,181                     |
| Commercial                                    | 207                       | 401                          |
| Agricultural                                  | -                         | -                            |
| Consumer                                      | 50                        | 15                           |
| Total nonaccrual loans                        | <u>2,717</u>              | <u>2,597</u>                 |
| Restructured loans                            |                           | -                            |
| Real estate                                   | 556                       | -                            |
| Commercial                                    | 144                       | -                            |
| Agricultural                                  | -                         | -                            |
| Consumer                                      | -                         | -                            |
| Total restructured loans                      | <u>700</u>                | <u>-</u>                     |
| Total nonperforming loans                     | <u>3,417</u>              | <u>2,597</u>                 |
| Foreclosed real estate                        | <u>3,532</u>              | <u>3,716</u>                 |
| Total nonperforming assets                    | <u>\$ 6,949</u>           | <u>\$ 6,313</u>              |

#### Impaired Loans

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

|   | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|---------------------------|------------------------------|
| <b>Impaired Loans</b><br>(in thousands) |                           |                              |
| Accruing                                | \$ -                      | \$ -                         |
| Nonaccruing                             | 1,396                     | 560                          |
| Total impaired laons                    | <u>\$ 1,396</u>           | <u>\$ 560</u>                |

Included in the impaired loan totals were \$700,000 in troubled debt restructured loans at March 31, 2011 and \$0 at December 31, 2010.

### Other Real Estate Owned (Foreclosed Assets)

Other real estate owned was carried on the consolidated balance sheets at \$3,532,000 at March 31, 2011 and \$3,716,000 at December 31, 2010. Other real estate owned is initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the allowance for loan losses at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell. For significant amounts, these valuations are typically outside annual appraisals.

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

|                                     | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------------|---------------------------|------------------------------|
| Construction and land development   | \$ 2,283                  | \$ 2,293                     |
| Farmland                            | -                         | -                            |
| 1-4 family residential              | 1,015                     | 1,078                        |
| Multifamily (5 or more) residential | -                         | -                            |
| Commercial real estate              | 234                       | 345                          |
|                                     | <u>\$ 3,532</u>           | <u>\$ 3,716</u>              |

### Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$663,483,000 at March 31, 2011 compared to \$640,098,000 at December 31, 2010, a \$23,385,000 or 3.7% increase. The most consistent source of deposit growth has been 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 \$109,372,000 at March 31, 2011 compared to \$108,087,000 at December 31, 2010, an increase of \$1,285,000 or 1.2%.

The Company paid cash dividends of \$0.23 per share during the first quarter of 2011 while the aggregate basic and diluted earnings per share for the same period were \$0.29 per share. The Company's current capital position provided the Board of Directors with the strategic flexibility to temporarily 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 March 31, 2011, the Company's Tier I and total capital ratios were 18.72% and 19.97%, respectively. At December 31, 2010, these ratios were 18.38% and 19.64%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 12.93% and 12.74% at March 31, 2011 and December 31, 2010, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

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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 March 31, 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):

|                                     | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------------|---------------------------|------------------------------|
| Commitments to extend credit        | \$ 137,458                | \$ 134,435                   |
| Standby letters of credit           | 2,241                     | 1,588                        |
| Mortgage loan rate-lock commitments | 1,820                     | 4,235                        |

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



### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### **Market Risk Management**

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

#### *Interest Rate Risk Management*

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

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

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position is asset sensitive. The simulation projects that if rates increase over a 12 month period by one percent, net interest income is expected to increase by 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 March 31, 2011, principal advance obligations to the FHLB consisted of \$4,450,000 in fixed-rate, long-term advances compared to \$8,488,000 in long-term advances and \$6,110,000 in short-term advances at December 31, 2010. The Company also had outstanding \$40 million in letters of credit at March 31, 2011 and \$20 million in letters of credit at December 31, 2010. The letters of credit provide the Bank with alternate collateral for securing public entity deposits above Federal Deposit Insurance Corporation insurance levels, thereby providing less need for collateral pledging from the securities portfolio.

The Company had fixed-rate term advance borrowing contracts with the FHLB as of March 31, 2011, with the following final maturities:

|    | <u>Amount</u>    | <u>Maturity Date</u> |
|----|------------------|----------------------|
| \$ | 4,000,000        | April 2011           |
|    | 450,000          | March 2014           |
| \$ | <u>4,450,000</u> |                      |

The Company has federal funds lines of credit established with two correspondent 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 March 31, 2011.

There have been no material changes to market risk as disclosed in the Company's 2010 Annual Report on Form 10-K. Refer to those disclosures for further information.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### *Disclosure Controls and Procedures*

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934), as amended (the "Exchange Act") as of March 31, 2011. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended March 31, 2011 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II

**OTHER INFORMATION**

Item:

1. Legal Proceedings  
The nature of the business of the Company ordinarily results in a certain amount of litigation. The Company is involved in various legal proceedings, all of which are considered incidental to the normal conduct of business. Management believes that these proceedings will not have a material adverse effect on the consolidated financial position or consolidated results of operations of the Company.
- 1A. Risk Factors  
There have been no material changes to the risk factors disclosed in the Company's 2010 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 11, 2011.
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

**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 – May 9, 2011

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

Date – May 9, 2011

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

