

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED **June 30, 2012**.
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _ TO_.

Commission file number: 0-12820

AMERICAN NATIONAL BANKSHARES INC.

(Exact name of registrant as specified in its charter)

VIRGINIA

(State or other jurisdiction of
incorporation or organization)

628 Main Street
Danville, Virginia

(Address of principal executive offices)

54-1284688

(I.R.S. Employer
Identification No.)

24541

(Zip Code)

(434) 792-5111

(Registrant's telephone number, including area code)

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

Yes No

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

Yes No

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

Large accelerated filer
Smaller reporting company

Accelerated filer

Non-accelerated filer

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

Yes No

At August 6, 2012, the Company had 7,836,056 shares of Common Stock outstanding, \$1 par value.

AMERICAN NATIONAL BANKSHARES INC.

<u>Index</u>		<u>Page</u>
<u>Part I.</u>	FINANCIAL INFORMATION	
<u>Item 1.</u>	Financial Statements	
	Consolidated Balance Sheets as of June 30, 2012 and December 31, 2011	<u>3</u>
	Consolidated Statements of Income for the three months ended June 30, 2012 and 2011	<u>4</u>
	Consolidated Statements of Income for the six months ended June 30, 2012 and 2011	<u>5</u>
	Consolidated Statements of Comprehensive Income for the three months and six months ended June 30, 2012 and 2011	<u>6</u>
	Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2012 and 2011	<u>7</u>
	Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011	<u>8</u>
	Notes to Consolidated Financial Statements	<u>9</u>
<u>Item 2.</u>	Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>35</u>
<u>Item 3.</u>	Quantitative and Qualitative Disclosures about Market Risk	<u>54</u>
<u>Item 4.</u>	Controls and Procedures	<u>54</u>
<u>Part II.</u>	OTHER INFORMATION	
<u>Item 1.</u>	Legal Proceedings	<u>55</u>
<u>Item 1A.</u>	Risk Factors	<u>55</u>
<u>Item 2.</u>	Unregistered Sales of Equity Securities and Use of Proceeds	<u>55</u>
<u>Item 3.</u>	Defaults Upon Senior Securities	<u>55</u>
<u>Item 4.</u>	Mine Safety Disclosures	<u>55</u>
<u>Item 5.</u>	Other Information	<u>55</u>
<u>Item 6.</u>	Exhibits	<u>55</u>
<u>SIGNATURES</u>		

Part I. Financial Information
Item 1. Financial Statements

American National Bankshares Inc. and Subsidiaries
Consolidated Balance Sheets

(Dollars in thousands, except share data)

	(Unaudited) June 30, 2012	(Audited) December 31, 2011
Assets		
Cash and due from banks	\$ 18,529	\$ 22,561
Interest-bearing deposits in other banks	10,380	6,332
Securities available for sale, at fair value	334,523	333,366
Restricted stock, at cost	6,268	6,019
Loans held for sale	9,215	6,330
Loans, net of unearned income	808,069	824,758
Less allowance for loan losses	(12,099)	(10,529)
Net loans	<u>795,970</u>	<u>814,229</u>
Premises and equipment, net	25,314	25,674
Other real estate owned, net	4,731	5,353
Goodwill	39,352	38,899
Core deposit intangibles, net	5,502	6,595
Bank owned life insurance	13,273	13,058
Accrued interest receivable and other assets	27,835	26,290
Total assets	<u>\$ 1,290,892</u>	<u>\$ 1,304,706</u>
Liabilities		
Demand deposits -- noninterest bearing	\$ 196,727	\$ 179,148
Demand deposits -- interest bearing	149,229	189,212
Money market deposits	170,505	182,347
Savings deposits	78,842	74,193
Time deposits	447,182	433,854
Total deposits	<u>1,042,485</u>	<u>1,058,754</u>
Short-term borrowings:		
Customer repurchase agreements	46,113	45,575
Other short-term borrowings	-	3,000
Long-term borrowings	10,142	10,206
Trust preferred capital notes	27,267	27,212
Accrued interest payable and other liabilities	6,461	7,130
Total liabilities	<u>1,132,468</u>	<u>1,151,877</u>
Shareholders' equity		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 20,000,000 shares authorized, 7,836,056 shares outstanding at June 30, 2012 and 7,806,869 shares outstanding at December 31, 2011	7,836	7,807
Capital in excess of par value	56,825	56,395
Retained earnings	86,642	81,797
Accumulated other comprehensive income, net	7,121	6,830
Total shareholders' equity	<u>158,424</u>	<u>152,829</u>
Total liabilities and shareholders' equity	<u>\$ 1,290,892</u>	<u>\$ 1,304,706</u>

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

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

	Three Months Ended	
	June 30	
	2012	2011
Interest and Dividend Income:		
Interest and fees on loans	\$ 12,683	\$ 6,618
Interest and dividends on securities:		
Taxable	1,056	1,085
Tax-exempt	1,077	827
Dividends	52	26
Other interest income	18	14
Total interest and dividend income	<u>14,886</u>	<u>8,570</u>
Interest Expense:		
Interest on deposits	1,729	1,587
Interest on short-term borrowings	51	82
Interest on long-term borrowings	84	5
Interest on trust preferred capital notes	206	297
Total interest expense	<u>2,070</u>	<u>1,971</u>
Net Interest Income	12,816	6,599
Provision for Loan Losses	<u>733</u>	<u>336</u>
Net Interest Income After Provision for Loan Losses	<u>12,083</u>	<u>6,263</u>
Noninterest Income:		
Trust fees	966	878
Service charges on deposit accounts	413	400
Other fees and commissions	445	338
Mortgage banking income	519	271
Securities gains (losses), net	160	(19)
Other	297	120
Total noninterest income	<u>2,800</u>	<u>1,988</u>
Noninterest Expense:		
Salaries	3,809	2,546
Employee benefits	799	624
Occupancy and equipment	1,048	696
FDIC assessment	213	197
Bank franchise tax	182	176
Core deposit intangible amortization	546	95
Foreclosed real estate, net	171	456
Merger related expenses	(202)	835
Other	2,267	1,403
Total noninterest expense	<u>8,833</u>	<u>7,028</u>
Income Before Income Taxes	6,050	1,223
Income Taxes	1,776	211
Net Income	<u>\$ 4,274</u>	<u>\$ 1,012</u>
Net Income Per Common Share:		
Basic	\$ 0.55	\$ 0.16
Diluted	\$ 0.54	\$ 0.16
Average Common Shares Outstanding:		
Basic	7,832,162	6,154,396
Diluted	7,849,142	6,161,265

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

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

	Six Months Ended June 30	
	2012	2011
Interest and Dividend Income:		
Interest and fees on loans	\$ 25,803	\$ 13,297
Interest and dividends on securities:		
Taxable	2,135	2,254
Tax-exempt	2,159	1,543
Dividends	103	53
Other interest income	28	84
Total interest and dividend income	<u>30,228</u>	<u>17,231</u>
Interest Expense:		
Interest on deposits	3,566	3,167
Interest on short-term borrowings	94	162
Interest on long-term borrowings	168	58
Interest on trust preferred capital notes	412	640
Total interest expense	<u>4,240</u>	<u>4,027</u>
Net Interest Income	25,988	13,204
Provision for Loan Losses	<u>1,466</u>	<u>673</u>
Net Interest Income After Provision for Loan Losses	<u>24,522</u>	<u>12,531</u>
Noninterest Income:		
Trust fees	1,848	1,806
Service charges on deposit accounts	901	821
Other fees and commissions	902	654
Mortgage banking income	1,050	418
Securities gains (losses), net	160	(18)
Other	1,173	278
Total noninterest income	<u>6,034</u>	<u>3,959</u>
Noninterest Expense:		
Salaries	7,920	5,031
Employee benefits	1,877	1,165
Occupancy and equipment	2,013	1,395
FDIC assessment	446	402
Bank franchise tax	365	351
Core deposit intangible amortization	1,093	189
Foreclosed real estate, net	18	522
Merger related expenses	49	1,144
Other	4,979	2,608
Total noninterest expense	<u>18,760</u>	<u>12,807</u>
Income Before Income Taxes	11,796	3,683
Income Taxes	<u>3,347</u>	<u>893</u>
Net Income	<u>\$ 8,449</u>	<u>\$ 2,790</u>
Net Income Per Common Share:		
Basic	\$ 1.08	\$ 0.45
Diluted	\$ 1.08	\$ 0.45
Average Common Shares Outstanding:		
Basic	7,827,195	6,149,029
Diluted	7,839,364	6,157,032

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income
June 30, 2012

(Dollars in thousands) (Unaudited)

	Three Months Ended June 30	
	2012	2011
Net income	\$ 4,274	\$ 1,012
Other comprehensive income:		
Unrealized gains on securities available for sale	1,285	3,195
Income tax (benefit)	(450)	(1,119)
Reclassification adjustment for (gains) losses on securities	(160)	19
Income tax expense (benefit)	56	(6)
Other comprehensive income	731	2,089
Comprehensive income	<u>\$ 5,005</u>	<u>\$ 3,101</u>

	Six Months Ended June 30	
	2012	2011
Net income	\$ 8,449	\$ 2,790
Other comprehensive income:		
Unrealized gains on securities available for sale	608	4,155
Income tax (benefit)	(213)	(1,455)
Reclassification adjustment for (gains) losses on securities	(160)	18
Income tax expense (benefit)	56	(6)
Other comprehensive income	291	2,712
Comprehensive income	<u>\$ 8,740</u>	<u>\$ 5,502</u>

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

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

Six Months Ended June 30, 2012 and 2011

(Dollars in thousands) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2010	\$ 6,128	\$ 27,268	\$ 74,850	\$ (159)	\$ 108,087
Net income	-	-	2,790	-	2,790
Other comprehensive income	-	-	-	2,712	2,712
Stock options exercised	11	162	-	-	173
Stock option expense	-	32	-	-	32
Equity based compensation	18	208	-	-	226
Cash dividends declared, \$0.46 per share	-	-	(2,830)	-	(2,830)
Balance, June 30, 2011	<u>\$ 6,157</u>	<u>\$ 27,670</u>	<u>\$ 74,810</u>	<u>\$ 2,553</u>	<u>\$ 111,190</u>
Balance, December 31, 2011	\$ 7,807	\$ 56,395	\$ 81,797	\$ 6,830	\$ 152,829
Net income	-	-	8,449	-	8,449
Other comprehensive income	-	-	-	291	291
Stock options exercised	3	42	-	-	45
Equity based compensation	26	388	-	-	414
Cash dividends declared, \$0.46 per share	-	-	(3,604)	-	(3,604)
Balance, June 30, 2012	<u>\$ 7,836</u>	<u>\$ 56,825</u>	<u>\$ 86,642</u>	<u>\$ 7,121</u>	<u>\$ 158,424</u>

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

American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Six Months Ended June 30, 2012 and 2011
(Dollars in thousands) (Unaudited)

	2012	2011
Cash Flows from Operating Activities:		
Net income	\$ 8,449	\$ 2,790
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,466	673
Depreciation	865	598
Core deposit intangible amortization	1,093	189
Net amortization (accretion) of securities	1,667	581
Net accretion of fair value adjustments	(5,306)	
Net (gain) loss on sale or call of securities	(160)	18
Gain on loans held for sale	(926)	(360)
Proceeds from sales of loans held for sale	41,030	20,059
Originations of loans held for sale	(42,989)	(18,651)
Net (gain) loss on foreclosed real estate	(381)	76
Valuation allowance on foreclosed real estate	219	359
Net gain on sale of premises and equipment	(495)	-
Stock-based compensation expense	-	32
Equity based compensation	414	226
Deferred income tax expense (benefit)	2,238	(355)
Net change in interest receivable	(12)	172
Net change in other assets	(4,596)	190
Net change in interest payable	(71)	(179)
Net change in other liabilities	(597)	1,270
Net cash provided by operating activities	<u>1,908</u>	<u>7,688</u>
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	4,209	2,099
Proceeds from maturities and calls of securities available for sale	33,574	44,617
Proceeds from maturities and calls of securities held to maturity	-	961
Purchases of securities available for sale	(39,999)	(45,852)
Net change in restricted stock	(249)	-
Net decrease in loans	19,186	5,677
Proceeds from sale of premises and equipment	563	31
Purchases of premises and equipment	(573)	(249)
Proceeds from sales of foreclosed real estate	3,489	442
Net cash provided by investing activities	<u>20,200</u>	<u>7,726</u>
Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	(29,597)	24,022
Net change in time deposits	13,602	(5,170)
Net change in customer repurchase agreements	538	3,245
Net change in other short-term borrowings	(3,000)	(6,110)
Net change in long-term borrowings	(76)	(8,075)
Net change in trust preferred capital notes	-	-
Common stock dividends paid	(3,604)	(2,830)
Proceeds from exercise of stock options	45	173
Net cash (used in) provided by financing activities	<u>(22,092)</u>	<u>5,255</u>
Net Increase in Cash and Cash Equivalents	16	20,669
Cash and Cash Equivalents at Beginning of Period	<u>28,893</u>	<u>18,514</u>
Cash and Cash Equivalents at End of Period	<u>\$ 28,909</u>	<u>\$ 39,183</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. (the “Company”) and its wholly owned subsidiary, American National Bank and Trust Company (the “Bank”). The Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

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

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “AMNB 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.

On July 1, 2011, the Company completed its merger with MidCarolina Financial Corporation (“MidCarolina”). MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank.

In July 2011, and in connection with its acquisition of MidCarolina, the Company assumed the liabilities of the MidCarolina I and MidCarolina Trust II, two separate Delaware statutory trusts (the “MidCarolina Trusts”), which were also formed for the purpose of issuing preferred securities. Refer to Note 9 for further details concerning these entities.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the AMNB Trust and the MidCarolina Trusts, 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 June 30, 2012; the consolidated statements of income for the three and six months ended June 30, 2012 and 2011; the consolidated statements of comprehensive income for the three and six months ended June 30, 2012 and 2011; the consolidated statements of changes in shareholders’ equity for the six months ended June 30, 2012 and 2011; and the consolidated statements of cash flows for the six months ended June 30, 2012 and 2011. Operating results for the three and six month periods ended June 30, 2012 are not necessarily indicative of the results that may occur for the year ending December 31, 2012. 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, 2011.

Note 2 – Merger with MidCarolina

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

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

The Company issued 1,626,157 shares of additional common stock in connection with the MidCarolina merger. This represents 20.8% of the outstanding shares of the Company as of June 30, 2012.

In connection with the transaction, MidCarolina Bank was merged with and into the Bank.

On November 15, 2011, the Company repurchased all 5,000 shares of the Series A preferred stock issued in the merger. The shares had a \$1,000 liquidation preference per share. While the Series A preferred stock was subject to redemption at 104.5% of par during the twelve month period beginning August 15, 2011, the Company paid 62% of par, or an aggregate purchase price of \$3.1 million, to repurchase all 5,000 outstanding shares from the sole holder of the securities.

The merger with MidCarolina was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration paid were recorded at their estimated fair values as of the merger date. The excess of consideration paid over the fair value of net assets acquired was originally recorded as goodwill in the amount of approximately \$16.4 million, which will not be amortizable and is not deductible for tax purposes. The Company allocated the total balance of goodwill to its community banking segment. The Company also recorded \$6.6 million in core deposit intangibles which will be amortized over nine years using a declining balance method.

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

(dollars in thousands)	
Consideration Paid:	
Common shares issued (1,626,157)	\$ 29,905
Cash paid to Shareholders	12
Fair Value of Options	132
Preferred shares issued (5,000)	5,000
Value of consideration	35,049
Assets acquired:	
Cash and cash equivalents	34,783
Investment securities	51,442
Loans held for sale	113
Loans, net of unearned income	328,123
Premises and equipment, net	5,708
Deferred income taxes	15,310
Core deposit intangible	6,556
Other real estate owned	3,538
Other assets	13,535
Total assets	459,108
Liabilities assumed:	
Deposits	420,248
FHLB advances	9,858
Other borrowings	6,546
Other liabilities	4,291
Total Liabilities	440,943
Net assets acquired	18,165
Goodwill resulting from merger with MidCarolina	\$ 16,884

The following table details the changes in the fair value of net assets acquired and liabilities assumed from the amounts originally reported in the Form 10-K for the period ending December 31, 2011 (in thousands).

Goodwill at December 31, 2011	\$16,431
Effect of adjustments to:	
Other liabilities	453
Goodwill at June 30, 2012	<u>\$16,884</u>

The increase in goodwill made during the first quarter of 2012 was due to a change in estimated tax refunds due to MidCarolina.

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating the cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was that of acquired loans. The Company acquired the \$367.4 million loan portfolio at a fair value discount of \$39.9 million. The performing portion of the portfolio estimated fair value was \$286.5 million. The excess of expected cash flows above the fair value of the performing portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 310-20 (formerly SFAS 91).

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

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

Contractually required principal and interest at acquisition	\$ 56,681
Contractual cash flows not expected to be collected (nonaccretable difference)	17,472
Expected cash flows at acquisition	<u>39,209</u>
Interest component of expected cash flows (accretable discount)	1,663
Fair value of acquired loans accounted for under FASB ASC 310-30	<u>\$ 37,546</u>

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

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

In connection with the merger with MidCarolina, the Company recorded a deferred income tax asset of \$15.3 million related to MidCarolina’s valuation allowance on foreclosed real estate and bad debt expenses, as well as other tax attributes of the acquired company, along with the effects of fair value adjustments resulting from applying the acquisition method of accounting.

In connection with the merger with MidCarolina, the Company acquired other real estate owned with a fair value of \$3.5 million. Other real estate owned was measured at fair value less estimated cost to sell.

In connection with the merger with MidCarolina, the Company acquired premises and equipment with a fair value of \$5.7 million. Property appraisals for all owned locations were obtained. The fair value adjustment will be amortized as expense over the remaining lives of the properties. The Company also acquired several lease obligations in connection with the merger. The unfavorable lease position will be amortized over the remaining lives of the leases.

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

[Index](#)

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

The fair value of junior subordinated debentures (Other Borrowings) was determined based on the fair value of similar debt or equity instruments with reasonably comparable terms. This adjustment to the face value of the borrowings will be amortized to increase interest expense over the remaining lives of the respective borrowings.

Direct costs related to the acquisition were expensed as incurred. During the entire year of 2011, the Company incurred \$1,600,000 in merger and acquisition expenses. During 2012, the Company incurred \$49,000 in merger related expense, mostly related to the deconversion of MidCarolina to the Company’s operating system.

The following table presents unaudited pro forma information as if the merger with MidCarolina had occurred on January 1, 2010. This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments, amortization of core deposit and other intangibles and related income tax effects. The pro forma information does not necessarily reflect the results of operations that would have occurred had the merger with MidCarolina occurred in 2010. In particular, expected operational cost savings are not reflected in the pro forma amounts.

	Six Months Ended
	Pro Forma
	June 30, 2011
(dollars in thousands)	
Net interest income	\$ 27,429
Provision for loan loss	(3,073)
Non-interest income	5,014
Non-interest expense	(21,506)
Income taxes	(2,359)
Net income	\$ 5,505

Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at June 30, 2012 and December 31, 2011 were as follows:

(in thousands)	June 30, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$ 36,823	\$ 357	\$ 3	\$ 37,177
Mortgage-backed and CMOs	95,222	1,866	206	96,882
State and municipal	180,058	11,979	15	192,022
Corporate	8,385	63	6	8,442
Total securities available for sale	<u>\$ 320,488</u>	<u>\$ 14,265</u>	<u>\$ 230</u>	<u>\$ 334,523</u>

(in thousands)	December 31, 2011			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$ 32,071	\$ 608	\$ -	\$ 32,679
Mortgage-backed and CMOs	102,444	1,874	414	103,904
State and municipal	182,952	11,454	1	194,405
Corporate	2,312	66	-	2,378
Total securities available for sale	<u>\$ 319,779</u>	<u>\$ 14,002</u>	<u>\$ 415</u>	<u>\$ 333,366</u>

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 June 30, 2012. 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 securities that have been in a continuous unrealized loss position are as follows:

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
	Federal agencies and GSEs	\$ 2,038	\$ 3	\$ 2,038	\$ 3	\$ -
Mortgage-backed CMOs	17,215	120	17,215	120	-	-
State and municipal	2,586	86	2,586	86	-	-
Corporate	2,423	15	2,022	15	401	1
Total	<u>\$ 26,681</u>	<u>\$ 230</u>	<u>\$ 26,280</u>	<u>\$ 229</u>	<u>\$ 401</u>	<u>\$ 1</u>

GSE debt securities: The unrealized losses on investments in one GSEs ("government sponsored entities") was caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost basis 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 June 30, 2012.

GSE residential mortgage-backed securities: The unrealized losses on the Company's investment in 11 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 basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2012.

Collateralized Mortgage Obligations ("CMOs"): The unrealized loss associated with one CMO was caused by interest rate increases. The contractual cash flows of these 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 basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2012.

State and municipal securities: The unrealized losses on four investments in state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis 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 June 30, 2012.

Corporate securities: The unrealized losses on two investments in corporate securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis 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 June 30, 2012.

The Company's investment in FHLB stock totaled \$3,408,000 at June 30, 2012. 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 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 June 30, 2012 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, 2011.

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated	Unrealized	Estimated	Unrealized	Estimated	Unrealized
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
Mortgage-backed	\$ 28,431	\$ 266	\$ 28,431	\$ 266	\$ -	\$ -
Private label CMOs	3,375	148	3,306	115	69	33
State and municipal	401	1	401	1	-	-
Total	\$ 32,207	\$ 415	\$ 32,138	\$ 382	\$ 69	\$ 33

Other-Than-Temporary-Impaired Securities

As of June 30, 2012 and December 31, 2011, there were no securities classified as other-than-temporary impaired.

Note 4 - Loans

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

(in thousands)	June 30, 2012	December 31, 2011
Commercial	\$ 128,846	\$ 134,166
Commercial real estate:		
Construction and land development	50,913	54,433
Commercial real estate	354,441	351,961
Residential real estate:		
Residential	170,893	179,812
Home equity	95,522	96,195
Consumer	7,454	8,191
Total loans	<u>\$ 808,069</u>	<u>\$ 824,758</u>

Interest income, including accretion, on loans acquired from MidCarolina for the three months ended June 30, 2012 was approximately \$7.7 million and \$12.9 million for the six months ended June 30, 2012. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2012 and December 31, 2011 are as follows:

(in thousands)	June 30, 2012	December 31, 2011
Outstanding principal balance	\$ 275,667	\$ 321,002
Carrying amount	255,840	293,569

The outstanding principal balance and related carrying amount of acquired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), to account for interest earned, at June 30, 2012 and December 31, 2011 are as follows:

(in thousands)	June 30, 2012	December 31, 2011
Outstanding principal balance	\$ 32,307	\$ 45,760
Carrying amount	24,633	34,027

The following table presents changes in the accretable discount on acquired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), for the six months ended June 30, 2012. The accretion reflected below includes \$1,686,000 related to loan payoffs.

(in thousands)	Accretable Discount
Balance at December 31, 2011	\$ 1,056
Accretion	(1,738)
Reclassification from nonaccretable difference	1,917
Balance at June 30, 2012	<u>\$ 1,235</u>

The following table shows an analysis by portfolio segment of the Company's past due loans at June 30, 2012.

(in thousands)	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing		Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$ 170	\$ 128	\$ -	\$ 1,095	\$ 1,393	\$ 127,453	\$ 128,846	
Commercial real estate:								
Construction and land development	-	-	-	1,257	1,257	49,656	50,913	
Commercial real estate	981	1,596	-	1,996	4,573	349,868	354,441	
Residential:								
Residential	719	176	-	3,095	3,990	166,903	170,893	
Home equity	308	13	-	551	872	94,650	95,522	
Consumer	17	50	-	1	68	7,386	7,454	
Total	\$ 2,195	\$ 1,963	\$ -	\$ 7,995	\$ 12,153	\$ 795,916	\$ 808,069	

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2011.

(in thousands)	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing		Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$ 98	\$ 99	\$ -	\$ 1,820	\$ 2,017	\$ 132,149	\$ 134,166	
Commercial real estate:								
Construction and land development	1,086	1,163	-	5,819	8,066	46,367	54,433	
Commercial real estate	1,052	471	-	2,115	3,638	348,323	351,961	
Residential:								
Residential	1,519	741	-	3,476	5,735	174,077	179,812	
Home equity	270	243	197	244	954	95,241	96,195	
Consumer	126	7	-	49	181	8,010	8,191	
Total	\$ 4,151	\$ 2,724	\$ 197	\$ 13,523	\$ 20,591	\$ 804,167	\$ 824,758	

The following table presents the Company's impaired loan balances by portfolio segment excluding loans acquired with deteriorated credit quality at June 30, 2012.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 214	\$ 382	\$ -	\$ 210	\$ -
Commercial real estate:					
Construction and land development	2,081	701	-	1,407	15
Commercial real estate	153	153	-	765	5
Residential:					
Residential	1,029	1,327	-	1,149	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 3,477</u>	<u>\$ 2,563</u>	<u>\$ -</u>	<u>\$ 3,531</u>	<u>\$ 20</u>
With an related allowance recorded:					
Commercial	259	259	158	14	7
Commercial real estate:					
Construction and land development	-	-	-	-	-
Commercial real estate	233	233	69	19	8
Residential	289	289	114	48	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 781</u>	<u>\$ 781</u>	<u>\$ 341</u>	<u>\$ 81</u>	<u>\$ 15</u>
Total:					
Commercial	\$ 473	\$ 641	\$ 158	\$ 224	\$ 7
Commercial real estate:					
Construction and land development	2,081	701	-	1,407	15
Commercial real estate	386	386	69	784	13
Residential:					
Residential	1,318	1,616	114	1,197	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 4,258</u>	<u>\$ 3,344</u>	<u>\$ 341</u>	<u>\$ 3,612</u>	<u>\$ 35</u>

The following table presents the Company's impaired loan balances by portfolio segment excluding loans acquired with deteriorated credit quality at December 31, 2011.

(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	\$ -	\$ -	\$ -	\$ 48	\$ -
Commercial real estate:					
Construction and land development	364	391	-	292	-
Commercial real estate	279	279	-	207	17
Residential:					
Residential	1,185	1,276	-	376	2
Home equity	89	89	-	50	3
Consumer	49	56	-	17	-
	<u>\$ 1,966</u>	<u>\$ 2,091</u>	<u>\$ -</u>	<u>\$ 990</u>	<u>\$ 22</u>
With an related allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate:					
Construction and land development	363	363	49	139	-
Commercial real estate	888	888	80	75	-
Residential:					
Residential	21	21	1	7	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 1,272</u>	<u>\$ 1,272</u>	<u>\$ 130</u>	<u>\$ 221</u>	<u>\$ -</u>
Total:					
Commercial	\$ -	\$ -	\$ -	\$ 48	\$ -
Commercial real estate:					
Construction and land development	727	754	49	431	-
Commercial real estate	1,167	1,167	80	282	17
Residential:					
Residential	1,206	1,297	1	383	2
Home equity	89	89	-	50	3
Consumer	49	56	-	17	-
	<u>\$ 3,238</u>	<u>\$ 3,363</u>	<u>\$ 130</u>	<u>\$ 1,211</u>	<u>\$ 22</u>

The following table shows the detail of loans modified as troubled debt restructurings ("TDRs") included in the impaired loan balances for the three and six month periods ended June 30, 2012.

(dollars in thousands)	Loans Modified as a TDR for the Three Months Ended June 30, 2012		
	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
Commercial	1	\$ 11	\$ 11
Commercial real estate:			
Construction and land development	2	1,411	1,411
Commercial real estate	1	4	4
Total	<u>4</u>	<u>\$ 1,426</u>	<u>\$ 1,426</u>

**Loans Modified as a TDR for the
Six Months Ended June 30, 2012**

(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	1	\$ 11	\$ 11
Commercial real estate:			
Construction and land development	7	2,188	2,081
Commercial real estate	1	4	4
Total	9	\$ 2,203	\$ 2,096

None of the loans modified as a TDR within the previous twelve months have subsequently defaulted during the six month period ending June 30, 2012.

The following table shows the Company's commercial loan portfolio broken down by internal risk grading as of June 30, 2012.

(in thousands)
Commercial and Consumer Credit Exposure
Credit Risk Profile by Internally Assigned Grade

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Residential	Home Equity
Pass	\$ 126,558	\$ 39,464	\$ 333,636	\$ 153,437	\$ 92,960
Special Mention	1,097	2,170	12,261	10,932	1,366
Substandard	1,191	9,279	8,544	6,524	1,196
Doubtful	-	-	-	-	-
Total	<u>\$ 128,846</u>	<u>\$ 50,913</u>	<u>\$ 354,441</u>	<u>\$ 170,893</u>	<u>\$ 95,522</u>

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	Consumer
Performing	\$ 7,365
Nonperforming	89
Total	<u>\$ 7,454</u>

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.

[Index](#)

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.

The following table shows the Company's commercial loan portfolio broken down by internal risk grading as of December 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	\$ 130,603	\$ 35,265	\$ 321,370	\$ 161,158	\$ 93,193
Special Mention	1,349	3,401	19,072	10,166	1,606
Substandard	2,214	15,767	11,519	8,488	1,396
Doubtful	-	-	-	-	-
Total	<u>\$ 134,166</u>	<u>\$ 54,433</u>	<u>\$ 351,961</u>	<u>\$ 179,812</u>	<u>\$ 96,195</u>

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	<u>Consumer</u>
Performing	\$ 8,050
Nonperforming	141
Total	<u>\$ 8,191</u>

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 as of the indicated dates and periods are presented below:

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

(in thousands)	<u>Six Months Ended June 30, 2012</u>	<u>Year Ended December 31, 2011</u>	<u>Six Months Ended June 30, 2011</u>
Allowance for Loan Losses			
Balance, beginning of period	\$ 10,529	\$ 8,420	\$ 8,420
Provision for loan losses	1,466	3,170	673
Charge-offs	(863)	(1,863)	(705)
Recoveries	967	802	356
Balance, end of period	<u>\$ 12,099</u>	<u>\$ 10,529</u>	<u>\$ 8,744</u>
Reserve for Unfunded Lending Commitments			
Balance, beginning of period	\$ 200	\$ 218	\$ 218
Provision for loan losses	6	(18)	9
Charge-offs	-	-	-
Balance, end of period	<u>\$ 206</u>	<u>\$ 200</u>	<u>\$ 227</u>

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at June 30, 2012.

(in thousands)	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Total</u>
Allowance for Loan Losses					
Balance as of December 31, 2011	\$ 1,236	\$ 5,719	\$ 3,412	\$ 162	\$ 10,529
Charge-offs	(287)	(232)	(314)	(30)	(863)
Recoveries	554	312	63	38	967
Provision	204	796	443	23	1,466
Balance as of June 30, 2012	<u>\$ 1,707</u>	<u>\$ 6,595</u>	<u>\$ 3,604</u>	<u>\$ 193</u>	<u>\$ 12,099</u>
Balances at June 30, 2012:					
Allowance for Loan Losses					
Individually evaluated for impairment	\$ 158	\$ 69	\$ 114	\$ -	\$ 341
Collectively evaluated for impairment	1,549	6,526	3,490	193	11,758
Total	<u>\$ 1,707</u>	<u>\$ 6,595</u>	<u>\$ 3,604</u>	<u>\$ 193</u>	<u>\$ 12,099</u>
Loans					
Individually evaluated for impairment	\$ 473	\$ 2,467	\$ 1,318	\$ -	\$ 4,258
Collectively evaluated for impairment	125,553	389,281	256,860	7,454	779,148
Loans acquired with deteriorated credit quality	2,820	13,606	8,237	-	24,663
Total	<u>\$ 128,846</u>	<u>\$ 405,354</u>	<u>\$ 266,415</u>	<u>\$ 7,454</u>	<u>\$ 808,069</u>

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at December 31, 2011.

(in thousands)	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Total</u>
Allowance for Loan Losses					
Balance as of December 31, 2010	\$ 751	\$ 4,631	\$ 2,921	\$ 117	\$ 8,420
Charge-offs	(163)	(702)	(871)	(127)	(1,863)
Recoveries	373	306	50	73	802
Provision	275	1,484	1,312	99	3,170
Balance as of December 31, 2011	<u>\$ 1,236</u>	<u>\$ 5,719</u>	<u>\$ 3,412</u>	<u>\$ 162</u>	<u>\$ 10,529</u>
Balance as of December 31, 2011:					
Allowance for Loan Losses					
Individually evaluated for impairment	\$ -	\$ 129	\$ 1	\$ -	\$ 130
Collectively evaluated for impairment	1,236	5,590	3,411	162	10,399
Total	<u>\$ 1,236</u>	<u>\$ 5,719</u>	<u>\$ 3,412</u>	<u>\$ 162</u>	<u>\$ 10,529</u>
Loans					
Individually evaluated for impairment	\$ -	\$ 1,894	\$ 1,295	\$ 49	\$ 3,238
Collectively evaluated for impairment	131,754	381,175	266,421	8,143	787,493
Loans acquired with deteriorated credit quality	2,411	23,325	8,291	-	34,027
Total	<u>\$ 134,165</u>	<u>\$ 406,394</u>	<u>\$ 276,007</u>	<u>\$ 8,192</u>	<u>\$ 824,758</u>

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analyses of smaller balance, homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national and local economic trends and conditions; and concentrations of credit.

Note 6 – Goodwill and Other Intangible Assets

Goodwill is subject to at least an annual assessment for impairment by applying a fair value test. An annual fair value-based test was performed in 2011 that determined the market value of the Company's shares exceeded the consolidated carrying value, including goodwill; therefore, there has been no impairment recognized in the value of goodwill.

Core deposit intangibles resulting from the Community First acquisition in April 2006 were \$3,112,000 and are being amortized over 99 months. Core deposit intangibles resulting from the MidCarolina acquisition in July 2011 were \$6,556,000 and are being amortized over 108 months.

The changes in the carrying amount of goodwill and intangibles for the six months ended June 30, 2012, are as follows (in thousands):

	<u>Goodwill</u>	<u>Intangibles</u>
Balance December 31, 2011	\$ 38,899	\$ 6,595
Additions	453	-
Amortization	-	(1,093)
Impairment	-	-
Balance June 30, 2012	<u>\$ 39,352</u>	<u>\$ 5,502</u>

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 or GSEs. 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 June 30, 2012 and December 31, 2011 (in thousands):

	<u>June 30, 2012</u>	<u>December 31, 2011</u>
Customer repurchase agreements	\$ 46,113	\$ 45,575
FHLB overnight borrowings	-	3,000
	<u>\$ 46,113</u>	<u>\$ 48,575</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, home equity lines of credit, and commercial real estate loans. 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 June 30, 2012, \$518,174,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of June 30, 2012 and December 31, 2011 (dollars in thousands):

<u>June 30, 2012</u>			<u>December 31, 2011</u>		
<u>Due by</u>	<u>Advance Amount</u>	<u>Weighted Average Rate</u>	<u>Due by</u>	<u>Advance Amount</u>	<u>Weighted Average Rate</u>
April 2014	\$ 262	3.78%	April 2014	\$ 337	3.78%
November 2017	9,880	2.98	November 2017	9,869	2.98
	<u>\$ 10,142</u>	<u>3.01%</u>		<u>\$ 10,206</u>	<u>3.01%</u>

The advance due in November 2017 is net of a valuation allowance of \$120,000. The original valuation allowance recorded on July 1, 2011 was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the States of Virginia and North Carolina. At June 30, 2012, the Bank's public deposits totaled \$117,989,000. 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 June 30, 2012, the Company had \$72,000,000 in letters of credit with the FHLB outstanding, as well as \$75,824,000 in government and agency securities to provide collateral for such deposits.

Note 9 – Trust Preferred Capital Notes

On April 7, 2006, the AMNB Trust, a Delaware statutory trust and a 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. Initially, the securities required quarterly distributions by the AMNB Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate resets quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to 20 consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

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

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

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

A description of the junior subordinated debt securities outstanding payable to the trusts is shown below:

Issuing Entity	Date Issued	Interest Rate	Maturity Date	(Amounts in thousands)	
				Principal Amount	
				June 30, 2012	December 31, 2011
AMNB Trust I	04-07-06	Libor plus 1.35%	06-30-36	\$ 20,619	\$ 20,619
MidCarolina I	10-29-02	Libor plus 3.45%	11-07-32	4,014	3,986
MidCarolina II	12-03-03	Libor plus 2.95%	10-07-33	2,634	2,607
				<u>\$ 27,267</u>	<u>\$ 27,212</u>

The principal amounts reflected for the MidCarolina Trusts are net of valuation allowances of \$1,141,000 and \$975,000, respectively. The original valuation allowances of \$1,197,000 and \$1,021,000 were recorded as a result of the merger with MidCarolina on July 1, 2011 and are being amortized into interest expense over the remaining lives of the respective borrowings.

Note 10 – Stock Based Compensation

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

Stock Options

Accounting guidance requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued.

A summary of stock option transactions for the six months ended June 30, 2012 is as follows:

	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value (\$000)</u>
Outstanding at December 31, 2011	268,639	\$ 23.94		
Granted	-			
Exercised	(2,761)	16.37		
Forfeited	-			
Outstanding at June 30, 2012	<u>265,878</u>	\$ 24.02	3.98 years	\$ 467
Exercisable at June 30, 2012	<u>265,878</u>	\$ 24.02	3.98 years	\$ 467

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 June 30, 2012, there was no unrecognized compensation expenses related to nonvested stock option grants.

Restricted Stock

The Company from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company’s common stock. The value of the stock awarded is established as the fair market value of the stock at the time of the grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. Restricted stock granted cliff vests over 24 to 36 months based on the term of the award.

Nonvested restricted stock activity for the six months ended June 30, 2012 is summarized in the following table.

<u>Restricted Stock</u>	<u>Shares</u>	<u>Weighted Average Grant Date Value</u>
Nonvested at January 1, 2012	38,349	\$ 20.53
Granted	15,290	19.30
Vested	8,712	21.36
Forfeited	-	-
Nonvested at June 30, 2012	<u>44,927</u>	\$ 19.95

As of June 30, 2012 and December 31, 2011, there was \$525,000 and \$404,000 in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.40 years. The share based compensation expense for nonvested restricted stock was \$174,000 and \$120,000 during the first six months of 2012 and 2011, respectively.

Starting in 2010, the Company began offering its directors an option with respect to director compensation. For 2012, the regular monthly retainer can be received in the form of either (i) \$1,000 in cash or (ii) shares of immediately vested but restricted stock with a market value of \$1,563. Monthly meeting fees can also be received as \$600 per meeting in cash or \$750 in immediately vested, but restricted stock. For 2012, 12 of 13 directors elected to receive stock in lieu of cash for their monthly retainer board meeting fees. Only outside directors receive board fees. The Company issued 11,136 and 5,476 shares and recognized share based compensation expense of \$240,000 and \$107,000 during the first six months of 2012 and 2011, respectively.

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.

Stock options on common stock which were not included in computing diluted earnings per share for the six month periods ended June 30, 2012 and 2011, because their effects were antidilutive, averaged 196,394 and 82,177, respectively.

	Three Months Ended			
	2012		2011	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,832,162	\$.55	6,154,396	\$.16
Effect of dilutive securities - stock options	16,980	(.01)	6,869	-
Diluted	7,849,142	\$.54	6,161,265	\$.16

	Six Months Ended			
	2012		2011	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,827,195	\$ 1.08	6,149,029	\$.45
Effect of dilutive securities - stock options	12,169	-	8,003	-
Diluted	7,839,364	\$ 1.08	6,157,032	\$.45

Stock options on common stock which were not included in computing diluted earnings per share for the six month periods ended June 30, 2012 and 2011, because their effects were antidilutive, averaged 196,394 and 82,177, respectively.

Note 12 – Employee Benefit Plans

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

Components of Net Periodic Benefit Cost (in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Service cost	\$ -	\$ 27	\$ -	\$ 54
Interest cost	97	101	194	202
Expected return on plan assets	(135)	(131)	(270)	(262)
Recognized net actuarial loss	83	40	166	80
Net periodic benefit cost	<u>\$ 45</u>	<u>\$ 37</u>	<u>\$ 90</u>	<u>\$ 74</u>

The plan was frozen in 2009.

Note 13 – Segment and Related Information

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

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

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

Amounts shown in the “Other” column includes activities of the Company which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of the Company’s interest income on deposits held by the Bank.

Segment information as of and for the three and six months ended June 30, 2012 and 2011, is shown in the following table.

(in thousands)	Three Months Ended June 30, 2012				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 14,886	\$ -	\$ 2	\$ (2)	\$ 14,886
Interest expense	1,865	-	207	(2)	2,070
Noninterest income	1,715	1,079	6	-	2,800
Income before income taxes	5,704	650	(304)	-	6,050
Net income	4,014	461	(201)	-	4,274
Depreciation and amortization	984	5	-	-	989
Total assets	1,289,971	-	921	-	1,290,892
Capital expenditures	-	-	-	-	-

(in thousands)	Three Months Ended June 30, 2011				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 8,570	\$ -	\$ 12	\$ (12)	\$ 8,570
Interest expense	1,686	-	297	(12)	1,971
Noninterest income	1,064	915	9	-	1,988
Income before income taxes	1,781	583	(1,141)	-	1,223
Net income	1,619	384	(991)	-	1,012
Depreciation and amortization	384	5	-	-	389
Total assets	841,369	-	4,647	-	846,016
Capital expenditures	146	-	-	-	146

(in thousands)	Six Months Ended June 30, 2012				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 30,228	\$ -	\$ 5	\$ (5)	\$ 30,228
Interest expense	3,832	-	413	(5)	4,240
Noninterest income	3,961	2,062	11	-	6,034
Income before income taxes	11,187	1,208	(599)	-	11,796
Net income	7,984	865	(400)	-	8,449
Depreciation and amortization	1,948	10	-	-	1,958
Total assets	1,289,971	-	921	-	1,290,892
Capital expenditures	573	-	-	-	573

Note 14 – Fair Value of Financial Instruments

Determination of Fair Value

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

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

Fair Value Hierarchy

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

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

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

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

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

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). Federal Reserve Bank of Richmond and FHLB 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 during the period (in thousands):

Description	Balance as of June 30, 2012	Fair Value Measurements at June 30, 2012 Using		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$ 37,177	\$ -	\$ 37,177	\$ -
Mortgage-backed and CMOs	96,882	-	96,882	-
State and municipal	192,022	-	192,022	-
Corporate	8,442	-	8,105	337
Total	\$ 334,523	\$ -	\$ 334,186	\$ 337

Description	Balance as of December 31, 2011	Fair Value Measurements at December 31, 2011 Using		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$ 32,679	\$ -	\$ 32,679	\$ -
Mortgage-backed and CMOs	103,904	-	103,904	-
State and municipal	194,405	-	194,405	-
Corporate	2,378	-	2,054	324
Total	\$ 333,366	\$ -	\$ 333,042	\$ 324

Description	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
	Balances as of January 1, 2012	Net Income	Other Comprehensive Income	Purchases, Sales, and Issuances	Transfer In (Out) of Level 3	Balances as of June 30, 2012
Total Realized / Unrealized Gains (Losses) Included in						
Securities available for sale:						
Corporate	\$ 324	\$ 13	\$ -	\$ -	\$ -	\$ 337
Total assets	\$ 324	\$ 13	\$ -	\$ -	\$ -	\$ 337

Certain assets are measured at fair value on a nonrecurring basis in accordance with U.S. 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 period ended June 30, 2012. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

[Index](#)

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

Other real estate owned ("OREO"): Property acquired in satisfaction of loans is carried at the lower of cost or market value. The value of real estate is determined utilizing an income or market valuation approach less cost to sell based on an appraisal conducted by an independent, licensed appraiser outside of the company using observable market data (Level 2). However, if the real estate 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. OREO is measured at fair value on a nonrecurring basis. Any initial fair value adjustment is charged against the allowance for loan loss. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest expense on the Consolidated Statements of Income.

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

Description	Fair Value Measurements at June 30, 2012			
	Balance as of June 30, 2012	Using		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$ 9,215	\$ -	\$ 9,215	\$ -
Impaired loans, net of valuation allowance	440	-	440	-
Other real estate owned	4,731	-	4,731	-

Description	Fair Value Measurements at December 31, 2011			
	Balance as of December 31, 2011	Using		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$ 6,330	\$ -	\$ 6,330	\$ -
Impaired loans, net of valuation allowance	1,142	-	1,142	-
Other real estate owned	5,353	-	5,353	-

The carrying values and estimated fair values of the Company's financial instruments as of June 30, 2012 are as follows (in thousands):

	Fair Value Measurements at June 30, 2012 using				
	Carrying Value	Quoted	Significant	Significant	Fair Value
		Prices in	Other	Unobservable	
		Active	Observable	Inputs	
	Markets for	Inputs	Level 3		
	Identical	Level 2		Balance	
	Assets	Level 1	Level 2	Level 3	Balance
Financial Assets:					
Cash and cash equivalents	\$ 28,909	\$ 28,909	\$ -	\$ -	\$ 28,909
Securities available for sale	334,523	-	334,186	337	334,523
Loans held for sale	9,215	-	9,215	-	9,215
Loans, net of allowance	795,970	-	787,894	-	787,894
Bank owned life insurance	13,273	-	13,273	-	13,273
Accrued interest receivable	5,106	-	5,106	-	5,106
Financial Liabilities:					
Deposits	\$ 1,042,485	\$ -	\$ 1,020,830	\$ -	\$ 1,020,830
Repurchase agreements	46,113	-	46,113	-	46,113
Other borrowings	10,142	-	11,078	-	11,078
Trust preferred capital notes	27,267	-	23,032	-	23,032
Accrued interest payable	758	-	758	-	758

The Company has one Level 3 security, a trust preferred security issued by a community bank. It is a Level 3 security under the three-tier fair value hierarchy because of an absence of observable inputs for these and similar securities in the debt markets. The Company acquired this security in connection with merger with MidCarolina and obtained an independent third party appraisal of the fair value at July 1, 2011. Because of the lack of observable inputs, the valuation was completed using a discounted cash flow computation, adjusted for an estimated default rate determined by reviewing industry statistics. The merger date initial fair value estimate of the security was 67.28% of its \$500,000 par, or \$336,000. Approximately \$147,000 of this impairment was attributed to factors other than credit, and \$17,000 was attributable to credit factors.

The carrying values and estimated fair values of the Company's financial instruments as of December 31, 2011 are as follows (in thousands):

	Fair Value Measurements at December 31, 2011 using				
	Carrying Value	Quoted	Significant	Significant	Fair Value
		Prices in	Other	Unobservable	
		Active	Observable	Inputs	
	Markets for	Level 2	Level 3		
	Identical	Level 1	Level 2	Level 3	Balance
	Assets	Level 1	Level 2	Level 3	Balance
Financial Assets:					
Cash and cash equivalents	\$ 28,893	\$ 28,893	\$ -	\$ -	\$ 28,893
Securities available for sale	333,366	-	333,042	324	333,366
Loans held for sale	6,330	-	6,330	-	6,330
Loans, net of allowance	814,229	-	811,573	-	811,573
Bank owned life insurance	13,058	-	13,058	-	13,058
Accrued interest receivable	5,091	-	5,091	-	5,091
Financial Liabilities:					
Deposits	\$ 1,058,754	\$ -	\$ 1,066,448	\$ -	\$ 1,066,448
Repurchase agreements	45,575	-	45,575	-	45,575
Other borrowings	13,206	-	13,064	-	13,064
Trust preferred capital notes	27,212	-	27,184	-	27,184
Accrued interest payable	857	-	857	-	857

[Index](#)

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

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

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

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

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

Bank owned life insurance. Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

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 other 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 June 30, 2012 and December 31, 2011, 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

	Six Months Ended	
	June 30,	
	2012	2011
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$ 18,529	\$ 15,873
Interest-bearing deposits in other banks	10,380	23,310
	<u>\$ 28,909</u>	<u>\$ 39,183</u>
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	\$ 4,547	\$ 4,183
Income taxes	.	1,141
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	2,705	674
Unrealized gain on securities available for sale	448	4,173

Note 16 – Recent Accounting Pronouncements

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

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

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

[Index](#)

In September 2011, the FASB issued ASU 2011-08, “Intangible – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment.” The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity’s financial statements for the most recent annual or interim period have not yet been issued. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, “Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities.” This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, “Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.” The amendments are being made to allow FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company has included the required disclosures in its consolidated financial statements.

Refer to the Company’s Annual Report on Form 10-K for the year ended December 31, 2011 for previously announced accounting pronouncements.

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. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). 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 completed merger with MidCarolina Financial Corporation and other mergers and acquisitions.

Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2012 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, (2) acquired loans with specific credit-related deterioration and (3) goodwill impairment.

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

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

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

Acquired Loans with Specific Credit-Related Deterioration

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

Goodwill Impairment

The Company tests goodwill on an annual basis or more frequently if events or circumstances indicate that there may have been impairment. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss in an amount equal to that excess. The goodwill impairment test requires management to make judgments in determining the assumptions used in the calculations. The goodwill impairment testing conducted by the Company in 2012 indicated that goodwill is not impaired and is properly recorded in the financial statements.

Non-GAAP Presentations

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

Internet Access to Corporate Documents

The Company provides access to its Securities and Exchange Commission (“SEC”) filings through a link on the Investors Relations page of the Company’s web site at www.amnb.com. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The 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.

ACQUISITION OF MIDCAROLINA FINANCIAL CORPORATION

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

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

The Company issued 1,626,157 shares of additional common stock in connection with the MidCarolina merger. This represents 20.8% of the outstanding shares of the Company’s common stock as of June 30, 2012.

In connection with the transaction, MidCarolina Bank was merged with and into the Bank.

On November 15, 2011, the Company repurchased all 5,000 shares of the Series A preferred stock issued in the merger. The shares had a \$1,000 liquidation preference per share. While the Series A preferred stock was subject to redemption at 104.5% of par during the twelve month period beginning August 15, 2011, the Company paid 62% of par, or an aggregate purchase price of \$3.1 million, to repurchase all 5,000 outstanding shares from the sole holder of the securities.

The acquisition has been accretive to earnings. Most of the material changes in balance sheet and income statement categories during this reporting period are directly related to the impact of the MidCarolina merger.

MANAGEMENT INFORMATION SYSTEM CHANGES

In connection with the merger with MidCarolina, the Company converted its management information systems from an in-house data processing system to an outsourced processing strategy. Both banks’ management information systems were fully integrated and converted to Jack Henry & Associates Silverlake processing system in mid-February 2012.

RESULTS OF OPERATIONS**Earnings Performance****Three months ended June 30, 2012 and 2011**

For the quarter ended June 30, 2012, the Company reported net income of \$4,274,000 compared to \$1,012,000 for the comparable quarter in 2011. The \$3,262,000 or 322.3% increase in earnings was primarily due the positive impact of the July 2011 merger with MidCarolina. The merger generated \$2,796,000 in fair value and merger related adjustments, which represents approximately 46% of consolidated pretax income.

SUMMARY INCOME STATEMENT
(Dollars in thousands)

For the three months ended June 30,	2012	2011	\$ Change	% Change
Interest income	\$ 14,886	\$ 8,570	\$ 6,316	73.7%
Interest expense	(2,070)	(1,971)	(99)	5.0%
Net interest income	12,816	6,599	6,217	94.2%
Provision for loan losses	(733)	(336)	(397)	118.2%
Noninterest income	2,800	1,988	812	40.8%
Noninterest expense	(8,833)	(7,028)	(1,805)	25.7%
Income tax expense	(1,776)	(211)	(1,565)	741.7%
Net income	\$ 4,274	\$ 1,012	\$ 3,262	322.3%

Six months ended June 30, 2012 and 2011

For the six month period ended June 30, 2012, the Company reported net income of \$8,449,000 compared to \$2,790,000 for the comparable period in 2011. The \$5,659,000 or 202.8% increase in earnings was primarily due the positive impact of the July 2011 merger with MidCarolina. The 2011 period was negatively impacted by costs associated with the merger. The merger generated \$5,098,000 in fair value and merger related adjustments, which represents approximately 43% of consolidated pretax income.

SUMMARY INCOME STATEMENT
(Dollars in thousands)

For the six months ended June 30,	2012	2011	\$ Change	% Change
Interest income	\$ 30,228	\$ 17,231	\$ 12,997	75.4%
Interest expense	(4,240)	(4,027)	(213)	5.3%
Net interest income	25,988	13,204	12,784	96.8%
Provision for loan losses	(1,466)	(673)	(793)	117.8%
Noninterest income	6,034	3,959	2,075	52.4%
Noninterest expense	(18,760)	(12,807)	(5,953)	46.5%
Income tax expense	(3,347)	(893)	(2,454)	274.8%
Net income	\$ 8,449	\$ 2,790	\$ 5,659	202.8%

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 June 30, 2012 and 2011

Net interest income on a taxable equivalent basis increased \$6,350,000 or 90.0%, for the second quarter of 2012 compared to the same quarter of 2011. This was due primarily to the impact of the merger with MidCarolina.

For the second quarter of 2012, the Company's yield on interest-earning assets was 5.28% compared to 4.67% for the second quarter of 2011. The cost of interest-bearing liabilities was 0.88% compared to 1.28%. The interest rate spread was 4.40% compared to 3.39%. The net interest margin, on a fully taxable equivalent basis, was 4.57% compared to 3.65%. The increase in yield on earning assets was primarily driven by the impact of the MidCarolina merger and loan related accretion, which included approximately \$800,000 in additional accretion related to the sale of several significant purchased credit impaired loans.

[Index](#)

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended June 30, 2012 and 2011. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

Net Interest Income Analysis
For the Three Months Ended June 30, 2012 and 2011
(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2012	2011	2012	2011	2012	2011
Loans:						
Commercial	\$ 130,697	\$ 79,595	\$ 1,727	\$ 909	5.30%	4.58%
Real estate	681,870	430,872	10,859	5,620	6.37	5.22
Consumer	7,294	6,678	139	120	7.64	7.21
Total loans	<u>819,861</u>	<u>517,145</u>	<u>12,725</u>	<u>6,649</u>	<u>6.21</u>	<u>5.15</u>
Securities:						
Federal agencies	41,517	35,919	155	256	1.49	2.85
Mortgage-backed & CMOs	99,391	56,133	486	466	1.96	3.32
State and municipal	182,499	137,843	1,975	1,585	4.33	4.60
Other	12,589	5,830	117	57	3.72	3.91
Total securities	<u>335,996</u>	<u>235,725</u>	<u>2,733</u>	<u>2,364</u>	<u>3.25</u>	<u>4.01</u>
Deposits in other banks	<u>17,630</u>	<u>20,880</u>	<u>18</u>	<u>14</u>	<u>0.41</u>	<u>0.27</u>
Total interest-earning assets	<u>1,173,487</u>	<u>773,750</u>	<u>15,476</u>	<u>9,027</u>	<u>5.28</u>	<u>4.67</u>
Non-earning assets	<u>134,897</u>	<u>75,033</u>				
Total assets	<u>\$ 1,308,384</u>	<u>\$ 848,783</u>				
Deposits:						
Demand	\$ 155,550	\$ 98,224	54	17	0.14	0.07
Money market	172,439	61,714	127	67	0.30	0.44
Savings	78,608	63,716	30	22	0.15	0.14
Time	448,076	325,743	1,518	1,481	1.36	1.82
Total deposits	<u>854,673</u>	<u>549,397</u>	<u>1,729</u>	<u>1,587</u>	<u>0.81</u>	<u>1.16</u>
Customer repurchase agreements	48,742	47,220	49	82	0.40	0.70
Other short-term borrowings	1,878	-	2	-	0.43	-
Long-term borrowings	37,419	21,062	290	302	3.10	5.74
Total interest-bearing liabilities	<u>942,712</u>	<u>617,679</u>	<u>2,070</u>	<u>1,971</u>	<u>0.88</u>	<u>1.28</u>
Noninterest bearing demand deposits	199,754	116,928				
Other liabilities	8,528	3,317				
Shareholders' equity	<u>157,390</u>	<u>110,859</u>				
Total liabilities and shareholders' equity	<u>\$ 1,308,384</u>	<u>\$ 848,783</u>				
Interest rate spread					<u>4.40%</u>	<u>3.39%</u>
Net interest margin					<u>4.57%</u>	<u>3.65%</u>
Net interest income (taxable equivalent basis)			13,406	7,056		
Less: Taxable equivalent adjustment			<u>590</u>	<u>457</u>		
Net interest income			<u>\$ 12,816</u>	<u>\$ 6,599</u>		

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

	Three Months Ended June 30 2012 vs. 2011		
	Interest Increase (Decrease)	Change Attributable to	
		Rate	Volume
Interest income			
Loans:			
Commercial	\$ 818	\$ 161	\$ 657
Real Estate	5,239	1,441	3,798
Consumer	19	8	11
Total loans	<u>6,076</u>	<u>1,610</u>	<u>4,466</u>
Securities:			
Federal agencies	(101)	(136)	35
Mortgage-backed	20	(243)	263
State and municipal	390	(98)	488
Other securities	60	(3)	63
Total securities	<u>369</u>	<u>(480)</u>	<u>849</u>
Deposits in other banks	4	6	(2)
Total interest income	<u>6,449</u>	<u>1,136</u>	<u>5,313</u>
Interest expense			
Deposits:			
Demand	37	23	14
Money market	60	(27)	87
Savings	8	2	6
Time	<u>37</u>	<u>(435)</u>	<u>472</u>
Total deposits	142	(437)	579
Customer repurchase agreements	(33)	(36)	3
Other borrowings	(10)	(191)	181
Total interest expense	<u>99</u>	<u>(664)</u>	<u>763</u>
Net interest income	<u>\$ 6,350</u>	<u>\$ 1,800</u>	<u>\$ 4,550</u>

Six months ended June 30, 2012 and 2011

Net interest income on a taxable equivalent basis increased \$13,103,000 or 93.2%, for the six months ended June 30, 2012 compared to the comparable period in 2011. This was due primarily to the impact of the merger with MidCarolina.

For the first six months of 2012, the Company's yield on interest-earnings assets was 5.35% compared to 4.71% for the first six months of 2011. The cost of interest-bearing liabilities was 0.89% compared to 1.32%. The interest rate spread was 4.46% compared to 3.39%. The net interest margin, on a fully taxable equivalent basis, was 4.63% compared to 3.65%. The increase in yield on earning assets was primarily driven by the impact of the MidCarolina merger and loan related accretion, which included approximately \$1,700,000 in additional accretion related to the payoff and sale of several significant purchased credit impaired loans.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the six months ended June 30, 2012 and 2011. 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 Six Months Ended June 30, 2012 and 2011
 (in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2012	2011	2012	2011	2012	2011
Loans:						
Commercial	\$ 137,057	\$ 78,765	\$ 3,538	\$ 1,789	5.18%	4.58%
Real estate	674,964	431,775	21,977	11,315	6.51	5.24
Consumer	10,181	7,089	366	256	7.21	7.28
Total loans	<u>822,202</u>	<u>517,629</u>	<u>25,881</u>	<u>13,360</u>	<u>6.30</u>	<u>5.17</u>
Securities:						
Federal agencies	36,178	39,612	317	579	1.75	2.92
Mortgage-backed & CMOs	99,255	57,706	1,015	956	2.05	3.31
State and municipal	181,683	127,934	3,951	2,993	4.35	4.68
Other	10,462	5,933	211	115	4.03	3.88
Total securities	<u>327,578</u>	<u>231,185</u>	<u>5,494</u>	<u>4,643</u>	<u>3.35</u>	<u>4.02</u>
Deposits in other banks	<u>24,624</u>	<u>20,730</u>	<u>28</u>	<u>84</u>	<u>0.23</u>	<u>0.82</u>
Total interest-earning assets	<u>1,174,404</u>	<u>769,544</u>	<u>31,403</u>	<u>18,087</u>	<u>5.35</u>	<u>4.71</u>
Non-earning assets	<u>135,949</u>	<u>73,338</u>				
Total assets	<u>\$ 1,310,353</u>	<u>\$ 842,882</u>				
Deposits:						
Demand	\$ 163,014	\$ 97,465	110	35	0.14	0.07
Money market	179,180	62,416	288	150	0.32	0.48
Savings	77,557	63,114	59	43	0.15	0.14
Time	447,720	322,776	3,109	2,939	1.39	1.84
Total deposits	<u>867,471</u>	<u>545,771</u>	<u>3,566</u>	<u>3,167</u>	<u>0.82</u>	<u>1.17</u>
Customer repurchase agreements	47,986	45,500	92	162	0.38	0.72
Other short-term borrowings	997	68	2	-	0.47	0.47
Long-term borrowings	<u>37,420</u>	<u>24,439</u>	<u>580</u>	<u>698</u>	<u>3.10</u>	<u>5.71</u>
Total interest-bearing liabilities	<u>953,874</u>	<u>615,778</u>	<u>4,240</u>	<u>4,027</u>	<u>0.89</u>	<u>1.32</u>
Noninterest bearing demand deposits	191,517	113,890				
Other liabilities	8,925	3,168				
Shareholders' equity	<u>156,037</u>	<u>110,046</u>				
Total liabilities and shareholders' equity	<u>\$ 1,310,353</u>	<u>\$ 842,882</u>				
Interest rate spread					<u>4.46%</u>	<u>3.39%</u>
Net interest margin					<u>4.63%</u>	<u>3.65%</u>
Net interest income (taxable equivalent basis)			27,163	14,060		
Less: Taxable equivalent adjustment			<u>1,175</u>	<u>856</u>		
Net interest income			<u>\$ 25,988</u>	<u>\$ 13,204</u>		

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

	Six Months Ended June 30 2012 vs. 2011		
	Interest Increase (Decrease)	Change Attributable to	
		Rate	Volume
Interest income			
Loans:			
Commercial	\$ 1,749	\$ 272	\$ 1,477
Real Estate	10,662	3,209	7,453
Consumer	110	(1)	111
Total loans	<u>12,521</u>	<u>3,480</u>	<u>9,041</u>
Securities:			
Federal agencies	(262)	(215)	(47)
Mortgage-backed	59	(457)	516
State and municipal	958	(224)	1,182
Other securities	96	5	91
Total securities	<u>851</u>	<u>(891)</u>	<u>1,742</u>
Deposits in other banks	(56)	(69)	13
Total interest income	<u>13,316</u>	<u>2,520</u>	<u>10,796</u>
Interest expense			
Deposits:			
Demand	75	42	33
Money market	138	(64)	202
Savings	16	5	11
Time	170	(800)	970
Total deposits	<u>399</u>	<u>(817)</u>	<u>1,216</u>
Repurchase agreements	(70)	(78)	8
Other borrowings	(116)	(411)	295
Total interest expense	<u>213</u>	<u>(1,306)</u>	<u>1,519</u>
Net interest income	<u>\$ 13,103</u>	<u>\$ 3,826</u>	<u>\$ 9,277</u>

Noninterest Income

All comparisons discussed below are between the second quarter of 2012 and the second quarter of 2011. The major changes between periods are related to the impact of the July 2011 merger with MidCarolina, unless otherwise noted.

Noninterest income increased to \$2,800,000 in 2012 from \$1,988,000 in 2011, an increase of \$812,000 or 40.8%. The major factors impacting that change are discussed below.

Fees from the management of trusts, estates, and asset management accounts increased to \$966,000 in 2012 from \$878,000 in 2011, an increase of \$88,000 or 10.0%. 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 were \$413,000 in 2012 compared to \$400,000 in 2011, an increase of \$13,000 or 3.3%.

Other fees and commissions were \$445,000 in 2012 compared to \$338,000 in 2011, an increase of \$107,000 or 31.7%.

[Index](#)

Mortgage banking income was \$519,000 in 2012 compared to \$271,000 in 2011, an increase of \$248,000 or 91.5%. Mortgage banking has benefited from the historically low interest rates and from the merger.

Securities gains (losses), net were \$160,000 in gains in 2012 compared to \$(19,000) in losses in 2011.

Other income was \$297,000 in 2012 compared to \$120,000 in 2011, an increase of \$177,000 or 147.5%. The largest drivers of that increase were bank owned life insurance, which increased \$74,000, and brokerage income, which increased \$75,000.

Noninterest Expense

All comparisons discussed below are between the second quarter of 2012 and the second quarter of 2011. The major changes between periods are related to the impact of the July 2011 merger with MidCarolina, unless otherwise noted.

Noninterest expense was \$8,833,000 for 2012 compared to \$7,028,000 for 2011, an increase of \$1,805,000 or 25.7%. The major factors impacting that change are discussed below.

Salaries were \$3,809,000 for 2012 compared to \$2,546,000 for 2011, an increase of \$1,263,000 or 49.6%.

Employee benefits were \$799,000 for 2012 compared to \$624,000 for 2011, an increase of \$175,000 or 28.0%.

Occupancy expense was \$1,048,000 for 2012 compared to \$696,000 for 2011, an increase of \$352,000 or 50.6%.

The Federal Deposit Insurance Corporation ("FDIC") assessment for deposit insurance was \$213,000 for 2012 compared to \$197,000 for 2011, an increase of \$16,000 or 8.1%. The increase was mitigated by an over accrual in the 2011 period and a change in the method of premium computation by the FDIC.

Bank franchise tax expense was \$182,000 for 2012 compared to \$176,000 for 2011, an increase of \$6,000 or 3.4%

Core deposit intangible amortization was \$546,000 for 2012 compared to \$95,000 for 2011, an increase of \$451,000. This change was entirely related to the impact of the MidCarolina merger.

Foreclosed real estate, net, was \$171,000 for 2012 compared to \$456,000 for 2011, a \$285,000 improvement.

Merger related expenses were a credit of \$202,000 for 2012 compared to \$835,000 for 2011. The second quarter credit was the result of finalizing initial accruals to actual expense for the merger.

Other expenses were \$2,267,000 for 2012 compared to \$1,403,000 for 2011, an increase of \$864,000 or 61.6%. This increase was driven by a variety of increased costs post-merger, most notably supplies, up \$122,000, loan related expense, up \$100,000, advertising, up \$75,000, as well as numerous other items, increased by smaller amounts.

Income Taxes

The effective tax rate for the second quarter of 2012 was 29.4% compared to 17.3% for the second quarter of 2011.

The effective tax rate for the six months ended June 30, 2012 was 28.4% compared to 24.3% for the same period of 2011.

The effective tax rate is lower than the statutory rate of 35% 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.

Fair Value Impact to net Income

The following table presents the actual effect for the quarter ended June 30, 2012 of the accretible and amortizable fair value adjustments attributable to the MidCarolina merger on July 1, 2011 on net interest income and net income:

(in thousands)	Income Statement Effect	Remaining Premium/ (Discount) Balance on December 31, 2011	For the three months ended June 30, 2012	For the Six months ended June 30, 2012	Remaining Premium/ (Discount) Balance on June 30, 2012
Interest income/(expense):					
Loans	Income	\$ (15,908)	\$ 1,646	\$ 3,361	\$ (12,394) (1)
Accretible portion of loans acquired with deteriorated credit quality	Income	(1,056)	804	1,737	(1,235) (2)
Time deposits	Income	(110)	33	66	(44)
Time deposits - brokered	Income	(694)	104	208	(486)
FHLB advances	Expense	(131)	(6)	(12)	(119)
Trust preferred securities	Expense	(2,171)	(29)	(54)	(2,117)
Net Interest Income			2,552	5,306	
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 5,652	(452)	(904)	\$ 4,748
Net non-interest expense			(452)	(904)	
Change in pretax income			\$ 2,100	\$ 4,402	

(1) - Remaining discount balance includes \$153,000 in charge-offs against the mark

(2) - Remaining discount balance includes \$1,900,000 in reclassifications from the non-accretible difference

Accretion related to purchased credit impaired loans includes \$1,725,000 in accretion income associated with loan payoffs during the six month period.

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, state and municipal securities, and corporates comprise the portfolio.

[Index](#)

The available for sale securities portfolio was \$334,523,000 at June 30, 2012 compared to \$333,366,000 at December 31, 2011, an increase of \$1,157,000 or 0.3%. At June 30, 2012, the available for sale portfolio had an amortized cost of \$320,488,000, resulting in a net unrealized gain of \$14,035,000.

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, high quality, tax exempt securities, whose market values are not as volatile in rising rate environments as similarly termed taxable investments. The Company will attempt to deploy its cash to the maximum extent practical and prudent, consistent with its liquidity and asset liability strategy.

Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans.

Loans were \$808,069,000 at June 30, 2012 compared to \$824,758,000 at December 31, 2011, a decrease of \$16,689,000 or 2.0%. The net decrease in loans is primarily related to expected reductions in the loan portfolio acquired in the MidCarolina merger.

Loans held for sale totaled \$9,215,000 at June 30, 2012, and \$6,330,000 at December 31, 2011, an increase of \$2,885,000 or 45.6%.

Management of the loan portfolio is organized around segments. Each segment is comprised of 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 June 30, 2012 and December 31, 2011.

(in thousands)	<u>June 30, 2012</u>	<u>December 31, 2011</u>
Commercial	\$ 128,846	\$ 134,166
Commercial real estate:		
Construction and land development	50,913	54,433
Commercial real estate	354,441	351,961
Residential real estate:		
Residential	170,893	179,812
Home equity	95,522	96,195
Consumer	7,454	8,191
Total loans	<u>\$ 808,069</u>	<u>\$ 824,758</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 Committees 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.

[Index](#)

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 the 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. 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. 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. In addition, the Company is developing historical charge-off and recovery data on new loan production in the North Carolina market and renewals of previously existing performing loans in that market. 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 June 30, 2012, the allowance for loan losses was \$12,099,000 compared to \$10,529,000 at December 31, 2011. The allowance for loan losses as a percentage of loans was 1.50% and 1.28%, respectively. During the first six months of 2012, the allowance for loan losses increased by \$1,570,000 or 14.9% and the loan portfolio contracted by \$16,689,000 or 2.0%. As noted above, the Company considers numerous quantitative and qualitative factors in determining its allowance. Since July 2011, in the wake of the merger with MidCarolina, the Bank must also consider the velocity of accretion of the fair value, credit mark in relation to the amortization of the related loan balances. A large percentage of the Bank's North Carolina loan portfolio is commercial real estate, with relatively short maturities, with balloon payments, and relatively long amortization periods. This structure results in more rapid accretion of the mark than amortization of loan principal. While this is not a proximate cause in and of itself for additional provision, it does result in an increased volume of loans that must be evaluated for potential loss as they are renewed, on current market terms, and become part of the regular portfolio..

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

Summary of Loan Loss Experience
(in thousands)

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
Balance at beginning of period	\$ 10,529	\$ 8,420
Charge-offs:		
Construction and land development	191	529
Commercial real estate	41	173
Residential real estate	285	641
Home equity	29	230
Total real estate	546	1,573
Commercial and industrial	287	163
Consumer	30	127
Total charge-offs	863	1,863
Recoveries:		
Construction and land development	79	36
Commercial real estate	233	270
Residential real estate	58	40
Home equity	5	10
Total real estate	375	356
Commercial and industrial	554	373
Consumer	38	73
Total recoveries	967	802
Net charge-offs (recoveries)	(104)	1,061
Provision for loan losses	1,466	3,170
Balance at end of period	\$ 12,099	\$ 10,529

The provision for loan losses for the six month period in 2012 was \$1,466,000 and the provision for 2011 was \$3,170,000. The provision expense is determined in recognition of the larger size, complexity, and risk of the loan portfolio after the MidCarolina merger.

Net loans charge-offs (recoveries) totaled \$(104,000) for the six month period in 2012 and \$1,061,000 in 2011. Recoveries exceeded charge-offs in the six month period due to a large recovery of approximately \$600,000 of a loan previously charged-off by MidCarolina. Annualized net charge-offs (recoveries) to average loans during the same periods totaled (0.03)% and 0.14%, respectively.

Asset Quality Indicators

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

Asset Quality Ratios

	June 30, 2012	December 31, 2011
Allowance to loans (1)	1.50%	1.28%
Net charge-offs (recoveries) to allowance (2)	(1.72)	10.08
Net charge-offs (recoveries) to average loans (2)	(0.03)	0.16
Nonperforming assets to total assets (1)	0.99	1.46
Nonperforming loans to loans (1)	0.99	1.66
Provision to net charge-offs (recoveries) (2)	(1409.62)	298.77
Provision to average loans (2)	0.36	0.47
Allowance to nonperforming loans (1)	151.33	76.74
(1) - at quarter or year-end		
(2) - 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 that are not on nonaccrual. Nonperforming loans to total loans were 0.99% at June 30, 2012 and 1.66% at December 31, 2011.

Nonperforming assets include nonperforming loans and other real estate. Nonperforming assets represented 0.99% of total assets at June 30, 2012, down from 1.46% at December 31, 2011. Included in nonperforming assets were \$2,413,000 in troubled debt restructurings at June 30, 2012 and \$656,000 at December 31, 2011.

It is the policy of the Company that any loan that becomes 90 days past due will, in most cases, 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 \$7,995,000 in nonaccrual loans shown on the following table includes \$4,258,000 in impaired loans. These loans are exclusive of \$24,633,000 in loans acquired from MidCarolina with deteriorated credit quality. The remainder represents loans which were not deemed impaired because, based on performance and existing circumstances, management did not believe loss was probable and, accordingly, did not classify these loans as impaired.

The following table presents the Company's nonperforming assets.

Nonperforming Assets (in thousands)		
	June 30, 2012	December 31, 2011
Nonaccrual loans:		
Real estate	\$ 6,899	\$ 11,654
Commercial	1,095	1,820
Consumer	1	49
Total nonaccrual loans	<u>7,995</u>	<u>13,523</u>
Loans past due 90 days and accruing interest:		
Real estate	-	197
Total past due loans	<u>-</u>	<u>197</u>
Total nonperforming loans	<u>7,995</u>	<u>13,720</u>
Foreclosed real estate	<u>4,731</u>	<u>5,353</u>
Total nonperforming assets	<u>\$ 12,726</u>	<u>\$ 19,073</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.

Included in the impaired loan totals were \$2,413,000 in troubled debt restructured loans at June 30, 2012 and \$656,000 at December 31, 2011.

Impaired Loans (in thousands)		
	June 30, 2012	December 31, 2011
Accruing	\$ 1,315	\$ 313
Nonaccruing	1,532	2,925
Total impaired loans	<u>\$ 2,847</u>	<u>\$ 3,238</u>

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets were carried on the consolidated balance sheets at \$4,731,000 and \$5,353,000 as of June 30, 2012 and December 31, 2011, respectively. Foreclosed assets are 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 with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals.

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

Other Real Estate Owned
(in thousands)

	June 30, 2012	December 31, 2011
Construction and land development	\$ 3,729	\$ 3,001
Farmland	-	-
1-4 family residential	608	1,267
Multifamily (5 or more) residential	-	-
Commercial real estate	394	1,085
	<u>\$ 4,731</u>	<u>\$ 5,353</u>

Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$1,042,485,000 at June 30, 2012 compared to \$1,058,754,000 at December 31, 2011, a decrease of \$16,269,000 or 1.5%.

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 \$158,424,000 at June 30, 2012 compared to \$152,829,000 at December 31, 2011, an increase of \$5,595,000 or 3.7%.

The Company paid cash dividends of \$0.23 per share during the second quarter of 2012 while the aggregate basic and diluted earnings per share for the same period were \$0.55 and \$0.54 per share, respectively. The Company paid cash dividends of \$0.46 per share for the first half of 2012 while the basic and diluted earnings per share were \$1.08.

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 June 30, 2012, the Company's Tier I and total capital ratios were 14.87% and 16.12%, respectively. At December 31, 2011, these ratios were 14.36% and 15.55%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 10.81% and 10.23% at June 30, 2012 and December 31, 2011, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

As mandated by bank regulations, the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." These regulations require the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier I risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, and leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of June 30, 2012, that the Company met the requirements to be considered "well capitalized."

[Index](#)

As of July 2012, the banking regulators have published a notice of proposed regulations based on the Basel III international agreement. This NPR, if enacted in its current form, will have a significant impact on how regulatory capital is defined and computed, and how risk weighted assets are determined. At this point it is too early to determine the full impact of the proposed regulations, but it is reasonable to anticipate that there will be significant fluctuation in regulatory capital ratios throughout the industry.

Liquidity

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 Asset/Liability Investment Committee 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 June 30, 2012, principal advance obligations to the FHLB consisted of \$10,142,000 in fixed-rate, long-term advances compared to \$10,206,000 in long-term advances and \$3,000,000 in short-term advances at December 31, 2011. The Company also had outstanding \$72,700,000 in letters of credit at June 30, 2012 and \$72,000,000 in letters of credit at December 31, 2011. 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 June 30, 2012, with the following final maturities:

	Amount	Maturity Date
\$	263,000	March 2014
	9,879,000	November 2017
\$	<u>10,142,000</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 June 30, 2012.

As a result of the merger with MidCarolina, the Company acquired a relationship with Promontory Network, the sponsoring entity for the Certificate of Deposit Account Registry Service (“CDARS”). Through CDARS, the Company is able to provide deposit customers with access to aggregate FDIC insurance in amounts far exceeding \$250,000. This gives the Company the ability, as and when needed, to attract and retain large deposits from insurance and other safety conscious customers. CDARS are classified as brokered deposits, however they are generally derived from customers with whom our institution has or wishes to have a direct and ongoing relationship. As a result, management considers these deposits functionally in the same category as core deposits. With CDARS, the Company has the option to keep deposits on balance sheet or sell them to other members of the network. Additionally, subject to certain limits, the Bank can use CDARS purchase cost-effective funding without collateralization and in lieu of generating funds through traditional brokered CDs or the FHLB. In this manner, CDARS can provide the Company with another funding option. Thus, CDARS serves as a deposit-gathering tool and liquidity management tool.

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 subsidiaries to issue trust preferred securities, the Company does not have any off-balance sheet subsidiaries. Off-balance sheet transactions were as follows (in thousands):

	June 30, 2012	December 31, 2011
Commitments to extend credit	\$ 175,122	\$ 191,957
Standby letters of credit	4,929	2,961
Mortgage loan rate-lock commitments	7,442	5,387

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 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 2.7%. Management has no expectation that market rates will decline in the near term, given the prevailing economy.

There have been no material changes to market risk as disclosed in the Company's 2011 Annual Report on Form 10-K. Refer to those disclosures for further information.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934), as amended (the "Exchange Act"), as of June 30, 2012. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended June 30, 2012 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.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the Company's 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2012.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

Item 6. Exhibits

11.0 Refer to EPS calculation in the Notes to Financial Statements

31.1 Section 302 Certification of Charles H. Majors, Chairman 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, Chairman 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 – August 9, 2012

/s/ Charles H. Majors

Charles H. Majors
Chairman and Chief Executive Officer

Date – August 9, 2012

/s/ William W. Traynham

William W. Traynham
Senior Vice President and
Chief Financial Officer

