

AMERICAN NATIONAL BANKSHARES INC
Form 10-Q
May 09, 2007

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED **March 31, 2007.**

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

Commission file number 0-12820

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

VIRGINIA
(State or other jurisdiction of
incorporation or organization)

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

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

24541
(Zip Code)

(434) 792-5111
(Registrant's telephone number, including area code)

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

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes No

At May 8, 2007, the Company had 6,151,448 shares Common Stock outstanding, \$1 par value.

AMERICAN NATIONAL BANKSHARES INC.

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American National Bankshares Inc. and Subsidiary
Consolidated Balance Sheets

(Dollars in thousands, except share data)

| | (Unaudited) | (Audited) |
|---|-------------|-------------|
| | March 31, | December |
| | 2007 | 31, 2006 |
| ASSETS | | |
| Cash and due from banks | \$ 22,844 | \$ 24,375 |
| Interest bearing deposits in other banks | 22,817 | 1,749 |
| Securities available for sale, at fair value | 138,533 | 148,748 |
| Securities held to maturity (fair value of \$13,715 in 2007 and \$14,131 in 2006) | 13,475 | 13,873 |
| Total securities | 152,008 | 162,621 |
| Loans held for sale | 2,017 | 1,662 |
| Loans, net of unearned income | 543,357 | 542,228 |
| Less allowance for loan losses | (7,590) | (7,264) |
| Net loans | 535,767 | 534,964 |
| Bank premises and equipment at cost, less accumulated depreciation of \$15,022 in 2007 and \$14,755 in 2006 | 12,759 | 12,438 |
| Goodwill | 22,468 | 22,468 |
| Core deposit intangibles, net | 2,735 | 2,829 |
| Accrued interest receivable and other assets | 14,129 | 14,614 |
| Total assets | \$ 787,544 | \$ 777,720 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits -- noninterest bearing | \$ 116,940 | \$ 106,885 |
| Demand deposits -- interest bearing | 113,778 | 107,170 |
| Money market deposits | 52,856 | 50,948 |
| Savings deposits | 69,083 | 69,517 |
| Time deposits | 253,377 | 274,008 |
| Total deposits | 606,034 | 608,528 |
| Repurchase agreements | 44,526 | 33,368 |

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| | | |
|---|------------|------------|
| FHLB borrowings | 15,050 | 15,087 |
| Trust preferred capital notes | 20,619 | 20,619 |
| Accrued interest payable and other liabilities | 4,675 | 5,126 |
| Total liabilities | 690,904 | 682,728 |
| Shareholders' equity: | | |
| Preferred stock, \$5 par, 200,000 shares authorized, none outstanding | - | - |
| Common stock, \$1 par, 10,000,000 shares authorized, 6,156,823 shares outstanding at March 31, 2007 and 6,161,865 shares outstanding at December 31, 2006 | 6,157 | 6,162 |
| Capital in excess of par value | 26,456 | 26,414 |
| Retained earnings | 65,726 | 64,584 |
| Accumulated other comprehensive income (loss), net | (1,699) | (2,168) |
| Total shareholders' equity | 96,640 | 94,992 |
| Total liabilities and shareholders' equity | \$ 787,544 | \$ 777,720 |

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

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American National Bankshares Inc. and Subsidiary
Consolidated Statements of Income

(Dollars in thousands, except share and per share data)
(Unaudited)

Three Months Ended March 31,
2007 2006

| | | | |
|--|-----------|--------------|-----------------|
| Interest Income: | | | |
| Interest and fees on loans | \$ | 10,079 | \$ 6,956 |
| Interest and dividends on securities: | | | |
| Taxable | | 1,136 | 1,152 |
| Tax-exempt | | 423 | 451 |
| Dividends | | 89 | 57 |
| Other interest income | | 171 | 232 |
| Total interest income | | 11,898 | 8,848 |
| Interest Expense: | | | |
| Deposits | | 3,783 | 2,307 |
| Repurchase agreements | | 426 | 309 |
| Other borrowings | | 206 | 213 |
| Trust preferred capital notes | | 343 | - |
| Total interest expense | | 4,758 | 2,829 |
| Net Interest Income | | 7,140 | 6,019 |
| Provision for Loan Losses | | 303 | 126 |
| Net Interest Income After Provision for Loan Losses | | | |
| | | 6,837 | 5,893 |
| Noninterest Income: | | | |
| Trust fees | | 879 | 755 |
| Service charges on deposit accounts | | 622 | 571 |
| Other fees and commissions | | 289 | 309 |
| Mortgage banking income | | 190 | 133 |
| Securities gains, net | | 25 | 21 |
| Other | | 207 | 112 |
| Total noninterest income | | 2,212 | 1,901 |
| Noninterest Expense: | | | |
| Salaries | | 2,390 | 1,984 |
| Pension and other employee benefits | | 648 | 649 |
| Occupancy and equipment | | 829 | 646 |
| Bank franchise tax | | 168 | 140 |
| Core deposit intangible amortization | | 94 | 39 |
| Other | | 1,041 | 925 |
| Total noninterest expense | | 5,170 | 4,383 |
| Income Before Income Tax | | | |
| Provision | | 3,879 | 3,411 |
| Income Tax Provision | | 1,175 | 1,005 |
| Net Income | \$ | 2,704 | \$ 2,406 |
| Net Income Per Common Share: | | | |
| Basic | \$ | 0.44 | \$ 0.44 |
| Diluted | \$ | 0.44 | \$ 0.44 |

**Average Common Shares
Outstanding:**

| | | |
|---------|-----------|-----------|
| Basic | 6,156,812 | 5,441,758 |
| Diluted | 6,185,084 | 5,477,904 |

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

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American National Bankshares Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
 Three Months Ended March 31, 2007 and 2006
 (Unaudited)

| (Dollars in thousands) | Common Stock | | Capital in Excess of Par Value | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | | Total Shareholders' Equity |
|---|--------------|----------|--------------------------------|-------------------|---|---------|----------------------------|
| | Shares | Amount | | | Income (Loss) | | |
| | | | | | | | |
| Balance, December 31, 2005 | 5,441,758 | \$ 5,442 | \$ 9,588 | \$ 59,109 | | \$(720) | 73,419 |
| Net income | - | - | - | 2,406 | - | - | 2,406 |
| Change in unrealized losses on securities available for sale, net of tax of \$(178) | - | - | - | - | (343) | | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$(7) | - | - | - | - | (14) | | |
| Other comprehensive income (loss) | | | | | (357) | | (357) |
| Total comprehensive income | | | | | | | 2,049 |
| Stock repurchased and retired | (13,900) | (14) | (24) | (286) | - | | (324) |
| Stock options exercised | 3,580 | 3 | 46 | - | - | | 49 |

| | | | | | | |
|---|--------------|----------|-----------|-----------|-----------|---------|
| Cash dividends paid | - | - | - | (1,141) | - | (1,141) |
| Balance, March 31, 2006 | 5,431,438 \$ | 5,431 \$ | 9,610 \$ | 60,088 \$ | (1,077)\$ | 74,052 |
| Balance, December 31, 2006 | 6,161,865 \$ | 6,162 \$ | 26,414 \$ | 64,584 \$ | (2,168) | 94,992 |
| Net income | - | - | - | 2,704 | - | 2,704 |
| Change in unrealized gains on securities available for sale, net of tax of \$266 | - | - | - | - | 494 | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$ (13) | - | - | - | - | (25) | |
| Other comprehensive income | | | | | 469 | 469 |
| Total comprehensive income | | | | | | 3,173 |
| Stock repurchased and retired | (11,600) | (12) | (50) | (207) | - | (269) |
| Stock options exercised | 6,558 | 7 | 92 | - | - | 99 |
| Cash dividends paid | - | - | - | (1,355) | - | (1,355) |
| | 6,156,823 \$ | 6,157 \$ | 26,456 \$ | 65,726 \$ | (1,699)\$ | 96,640 |

**Balance, March
31, 2007**

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

Index**American National Bankshares Inc. and Subsidiary****Consolidated Statements of Cash Flows**

Three Months Ended March 31, 2007 and 2006

(in thousands)

(Unaudited)

| | 2007 | 2006 |
|---|----------|----------|
| Cash Flows from Operating Activities: | | |
| Net income | \$ 2,704 | \$ 2,406 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 303 | 126 |
| Depreciation | 282 | 211 |
| Core deposit intangible amortization | 94 | 39 |
| Net amortization (accretion) of bond premiums and discounts | (26) | 31 |
| Net gain on sale or call of securities | (25) | (21) |
| Gain on loans held for sale | (134) | (77) |
| Proceeds from sales of loans held for sale | 6,384 | 2,387 |
| Originations of loans held for sale | (6,605) | (2,469) |
| Net (gain) loss on foreclosed real estate | - | (3) |
| Gain on sale of premises and equipment | (9) | - |
| Deferred income tax expense (benefit) | (253) | 113 |
| Increase in interest receivable | (135) | (480) |
| Decrease in other assets | 802 | 1,606 |
| (Decrease) increase in interest payable | (53) | 68 |
| Decrease in other liabilities | (581) | (1,212) |
| Net cash provided by operating activities | 2,748 | 2,725 |
| Cash Flows from Investing Activities: | | |
| Proceeds from sales of securities available for sale | 215 | 165 |
| Proceeds from maturities and calls of securities available for sale | 13,522 | 14,473 |
| Proceeds from maturities and calls of securities held to maturity | 398 | 1,478 |
| Purchases of securities available for sale | (2,748) | (32,532) |
| Net (increase) decrease in loans | (1,106) | 5,651 |
| | - | 14 |

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| | | | |
|--|-----------|----|----------|
| Proceeds from sale of bank property and equipment | | | |
| Purchases of bank property and equipment | (594) | | (190) |
| Proceeds from sales of foreclosed real estate | - | | 66 |
| Net cash provided by (used in) investing activities | 9,687 | | (10,875) |
| Cash Flows from Financing Activities: | | | |
| Net increase in demand, money market, and savings deposits | 18,137 | | 13,859 |
| Net decrease in time deposits | (20,631) | | (831) |
| Net increase in repurchase agreements | 11,158 | | 3,469 |
| Net decrease in FHLB borrowings | (37) | | (38) |
| Cash dividends paid | (1,355) | | (1,141) |
| Repurchase of stock | (269) | | (324) |
| Proceeds from exercise of stock options | 99 | | 49 |
| Net cash provided by financing activities | 7,102 | | 15,043 |
| Net Increase in Cash and Cash Equivalents | 19,537 | | 6,893 |
| Cash and Cash Equivalents at Beginning of Period | 26,124 | | 27,354 |
| Cash and Cash Equivalents at End of Period | \$ 45,661 | \$ | 34,247 |
| Supplemental Schedule of Cash and Cash Equivalents: | | | |
| Cash: | | | |
| Cash and due from banks | \$ 22,844 | \$ | 17,986 |
| Interest-bearing deposits in other banks | 22,817 | | 16,261 |
| | \$ 45,661 | \$ | 34,247 |
| Supplemental Disclosure of Cash Flow Information: | | | |
| Interest paid | \$ 4,811 | \$ | 2,760 |
| Income taxes paid | - | | 11 |
| Transfer of loans to other real estate owned | - | | 30 |
| Unrealized gain (loss) on securities available for sale | 722 | | (542) |

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

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AMERICAN NATIONAL BANKSHARES INC. AND SUBSIDIARY
NOTES TO FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

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

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the Company's financial position as of March 31, 2007; the consolidated statements of income for the three months ended March 31, 2007 and 2006; the consolidated statements of changes in shareholders' equity for the three months ended March 31, 2007 and 2006; and the consolidated statements of cash flows for the three months ended March 31, 2007 and 2006. Operating results for the three month periods ended March 31, 2007 are not necessarily indicative of the results that may occur for the year ending December 31, 2007. Certain reclassifications have been made to prior period balances to conform to the current period presentation. The statements should be read in conjunction with the Notes to Financial Statements included in the Company's Form 10-K for the year ended December 31, 2006.

Note 2 - Securities

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

| (in thousands) | March 31, 2007 | | | |
|--|-------------------|---------------------|----------------------|----------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Securities available for sale: | | | | |
| Federal agencies | \$ 77,583 | \$ 103 | \$ 474 | \$ 77,212 |
| Mortgage-backed | 19,147 | 122 | 304 | 18,965 |
| State and municipal | 33,583 | 168 | 364 | 33,387 |
| Corporate | 2,487 | 1 | 48 | 2,440 |
| Equity securities: | | | | |
| FHLB stock - restricted | 2,130 | - | - | 2,130 |
| Federal Reserve stock - restricted | 1,429 | - | - | 1,429 |
| FNMA and FHLMC preferred stock | 2,453 | 436 | - | 2,889 |
| Other | 81 | - | - | 81 |
| Total securities available for sale | 138,893 | 830 | 1,190 | 138,533 |
| Securities held to maturity: | | | | |
| Federal agencies | 1,000 | - | 7 | 993 |
| Mortgage-backed | 365 | 9 | - | 374 |

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| | | | | |
|-----------------------------------|------------|----------|----------|------------|
| State and municipal | 12,110 | 264 | 26 | 12,348 |
| Total securities held to maturity | 13,475 | 273 | 33 | 13,715 |
| Total securities | \$ 152,368 | \$ 1,103 | \$ 1,223 | \$ 152,248 |

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

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The following table shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2007.

| (in thousands) | Total | | Less than 12 months | | 12 Months or More | |
|---------------------|------------|-----------------|---------------------|-----------------|-------------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Federal agencies | \$ 65,421 | \$ 481 | \$ 5,848 | \$ 15 | \$ 59,573 | \$ 466 |
| Mortgage-backed | 10,389 | 304 | 175 | 2 | 10,214 | 302 |
| State and municipal | 24,747 | 390 | 399 | - | 24,348 | 390 |
| Corporate | 1,437 | 48 | - | - | 1,437 | 48 |
| Total | \$ 101,994 | \$ 1,223 | \$ 6,422 | \$ 17 | \$ 95,572 | \$ 1,206 |

Management evaluates securities for other-than-temporary impairment quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The unrealized losses are attributable to interest rate changes and not credit concerns of the issuer. The Company has the intent and ability to hold these securities for the time necessary to recover the amortized cost. As of March 31, 2007, the Company held 135 securities that had been in a continuous unrealized loss position for twelve months or more.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position at December 31, 2006.

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

Note 3 - Loans

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

| (in thousands) | March 31, 2007 | December 31, 2006 |
|-----------------------------------|----------------|-------------------|
| Construction and land development | \$ 70,586 | \$ 69,404 |
| Commercial real estate | 196,339 | 186,639 |
| Residential real estate | 129,827 | 131,126 |
| Home equity | 48,004 | 52,531 |
| Total real estate | 444,756 | 439,700 |

| | | |
|---------------------------|------------|------------|
| Commercial and industrial | 88,808 | 91,511 |
| Consumer | 9,793 | 11,017 |
| Total loans | \$ 543,357 | \$ 542,228 |

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

| (in thousands) | March 31, 2007 | December 31, 2006 |
|---|----------------------|-------------------------|
| Impaired loans without a valuation allowance | \$ 1,219 | \$ 472 |
| Impaired loans with a valuation allowance | 295 | 904 |
| Total impaired loans | \$ 1,514 | \$ 1,376 |
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ 312 | \$ 241 |
| Nonaccrual loans excluded from the impaired loan disclosure | \$ 2,272 | \$ 2,311 |

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| (in thousands) | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|--|--|
| Average balance in impaired loans | \$ 1,587 | \$ 3,554 |
| Interest income recognized on impaired loans | \$ 4 | \$ 8 |
| Interest income recognized on nonaccrual loans | \$ - | \$ 24 |
| Interest on nonaccrual loans had they been accruing | \$ 75 | \$ 66 |
| Loans past due 90 days and still accruing interest | \$ - | \$ - |

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

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

Note 4 - Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for the three months ended March 31, 2007 and 2006, and for the year ended December 31, 2006 are presented below:

| (in thousands) | Three Months Ended March 31, 2007 | Year Ended December 31, 2006 | Three Months Ended March 31, 2006 |
|---|--|--|--|
| Allowance for Loan Losses | | | |
| Balance, beginning of period | \$ 7,264 | \$ 6,109 | \$ 6,109 |
| Allowance acquired in merger | - | 1,598 | - |
| Provision for loan losses | 303 | 58 | 126 |
| Charge-offs | (49) | (913) | (151) |
| Recoveries | 72 | 412 | 80 |
| Balance, end of period | \$ 7,590 | \$ 7,264 | \$ 6,164 |
| Reserve for unfunded lending commitments | | | |
| Balance, beginning of period | \$ 123 | - | \$ - |

| | | | | | | |
|------------------------------------|----|-----|----|-----|----|---|
| Provision for unfunded commitments | | 8 | | 123 | | - |
| Balance, end of period | \$ | 131 | \$ | 123 | \$ | - |

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

Index**Note 5 - Goodwill and Other Intangible Assets**

In January 2002, the Company adopted SFAS 142, *Goodwill and Other Intangible Assets*. Accordingly, goodwill is no longer subject to amortization, but is subject to at least an annual assessment for impairment by applying a fair value-based test.

The changes in the carrying amount of goodwill for the quarter ended March 31, 2007, are as follows (in thousands):

| | |
|-------------------------------------|-----------|
| Balance as of January 1, 2007 | \$ 22,468 |
| Goodwill recorded during the period | - |
| Impairment losses | - |
| Balance as of March 31, 2007 | \$ 22,468 |

Core deposit intangibles resulting from the Community First acquisition were \$3,112,000 and are being amortized over 99 months.

Note 6- Trust Preferred Securities

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

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

Note 7 - Stock Based Compensation

The Company maintained a stock option plan until its expiration on December 31, 2006, which provided for the granting of incentive and non-statutory options to employees on a periodic basis. The existing stock options are still covered by the plan although the plan expired at the end of 2006. The Company's stock options had an exercise price equal to the fair value of the stock on the date of grant. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard ("SFAS") 123R, *Share Based Payment*, using the modified prospective method and as

such, results for prior periods have not been restated. SFAS 123R requires public companies to recognize compensation expense related to stock based compensation awards, such as stock options and restricted stock, in their income statements over the period during which an employee is required to provide service in exchange for such award. SFAS 123R eliminated the choice to account for employee stock options under Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*.

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

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

Stock option plan activity for the three months ended March 31, 2007 is summarized below:

| | Shares | Weighted Average Exercise Price | Average Remaining Contractual Life (in years) | Average Intrinsic Value (in thousands) |
|-----------------------------------|---------|--|---|--|
| Options outstanding, January 1 | 201,849 | \$ 20.36 | | |
| Granted | - | - | | |
| Exercised | (6,558) | 14.92 | | |
| Forfeited | (120) | 14.00 | | |
| Outstanding at March 31 | 195,171 | \$ 20.54 | 4.6 | \$ 662 |
| Exercisable March 31 | 195,171 | 20.54 | 4.6 | 662 |

The total intrinsic value of options exercised during the three month period ended March 31, 2007 was \$48,000.

Note 8 - Earnings Per Share

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

| | Three Months Ended <u>March 31,</u> | | | |
|--|--|------------------------|-----------|------------------------|
| | 2007 | Per Share Amount | 2006 | Per Share Amount |
| | Shares | | Shares | |
| Basic earnings per share | 6,156,812 | \$.44 | 5,441,758 | \$.44 |
| Effect of dilutive securities (stock options) | 28,272 | - | 36,146 | - |
| Diluted earnings per share | 6,185,084 | \$.44 | 5,477,904 | \$.44 |

Stock options on common stock which were not included in computing diluted earnings per share for the three month periods ended March 31, 2007 and 2006 because their effects were antidilutive averaged 88,027 and 88,227, respectively.

Index**Note 9 - Employee Benefit Plans**

| Components of Net Periodic Benefit Cost (in thousands) | Three Months Ended | |
|--|--------------------|---------------|
| | <u>March 31,</u> | |
| | 2007 | 2006 |
| Service cost | \$ 164 | \$ 126 |
| Interest cost | 105 | 88 |
| Expected return on plan assets | (141) | (110) |
| Amortization of prior service cost | (1) | (6) |
| Recognized net actuarial loss | 38 | 53 |
| Net periodic benefit cost | \$ 165 | \$ 151 |

Note 10 - Segment and Related Information

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

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

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

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

Segment information for the three month periods ended March 31, 2007 and 2006 is shown in the following table.

| | Three Months Ended March 31, 2007 | | | | |
|------------------|-----------------------------------|-------------------------------------|-------|------------------------------|----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | Total |
| Interest income | \$ 8,848 | \$ - | \$ - | \$ - | \$ 8,848 |
| Interest expense | 2,829 | - | - | - | 2,829 |

| | | | | | |
|--|---------|-----|-------|---|---------|
| Non-interest income - external customers | 1,025 | 879 | (3) | - | 1,901 |
| Operating income before income taxes | 3,065 | 400 | (54) | - | 3,411 |
| Depreciation and amortization | 245 | 5 | 1 | - | 251 |
| Total assets | 638,266 | - | 1,185 | - | 639,451 |
| Capital expenditures | 190 | - | - | - | 190 |

Three Months Ended March 31, 2006

| | Trust and | | | | Total |
|--|--------------------------|----------------------------|--------------|----------------------------------|--------------|
| | Community Banking | Investment Services | Other | Intersegment Eliminations | |
| Interest income | \$ 8,848 | \$ - | \$ - | \$ - | \$ 8,848 |
| Interest expense | 2,829 | - | - | - | 2,829 |
| Non-interest income - external customers | 1,025 | 879 | (3) | - | 1,901 |
| Non-interest income - internal customers | - | - | - | - | - |
| Operating income before income taxes | 3,065 | 400 | (54) | - | 3,411 |
| Depreciation and amortization | 245 | 5 | 1 | - | 251 |
| Total assets | 638,266 | - | 1,185 | - | 639,451 |
| Capital expenditures | 190 | - | - | - | 190 |

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

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

This report contains forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Factors that may cause actual results to differ materially from those expected include the following:

- General economic or business conditions, either nationally or in the market areas in which the Company does business, may be less favorable than expected, resulting in such things as deterioration in credit quality, reduced demand for credit, and reductions in depositors' account balances.
 - Changes in interest rates could increase or reduce income.
- Competition among financial institutions may increase and competitors may have greater financial resources and develop products and technology that enable those competitors to compete more successfully than the Company.
- Businesses that the Company is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards.
 - Adverse changes may occur in the securities markets.

Reclassification

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

Critical Accounting Policies

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

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

The allowance for loan losses is an estimate of the losses inherent in the loan portfolio at the balance sheet date. The allowance and reserve is based on two basic principles of accounting: (i) Statement of Financial Accounting Standards ("SFAS") 5, *Accounting for Contingencies*, which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS 114, *Accounting by Creditors for Impairment of a Loan*, which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows, or values observable in the secondary market, and the loan balance.

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

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

Goodwill and Other Intangible Assets

The Company adopted SFAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value-based test. Additionally, under SFAS 142, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Branch acquisition transactions were outside the scope of SFAS 142 and, accordingly, intangible assets related to such transactions continued to amortize upon the adoption of SFAS 142. The costs of purchased deposit relationships and other intangible assets, based on independent valuation by a qualified third party, are being amortized over their estimated lives. Amortization expense charged to operations was \$94,000 and \$39,000 for the three month periods ended March 31, 2007 and 2006, respectively.

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Non-GAAP Presentations

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

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

New Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

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

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

Internet Access to Corporate Documents

The Company provides access to its SEC filings through a link on the Investors Relations page of the Company's web site at www.amnb.com. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

EXECUTIVE OVERVIEW

American National Bankshares Inc. is the holding company of American National Bank and Trust Company, a community bank with eighteen full service offices serving the areas of Danville, Pittsylvania County, Martinsville, Henry County, South Boston, Halifax County, Lynchburg, Bedford, Bedford County, Campbell County and portions of Nelson County in Virginia, along with portions of Caswell County in North Carolina. The Company also operates loan production offices in Greensboro, North Carolina, Lynchburg, Virginia, and Smith Mountain Lake, Virginia.

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

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

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

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ANALYSIS OF OPERATING RESULTS

Net Interest Income

Net interest income, the Company's largest source of revenue, is the excess of interest income over interest expense. Net interest income is influenced by a number of factors, including the volume and mix of interest earning assets and interest bearing liabilities, interest rates earned on earning assets, and interest rates paid on deposits and borrowed funds. For analytical purposes, net interest income is adjusted to a taxable equivalent basis to recognize the income tax savings on tax-exempt assets, such as state and municipal securities. A tax rate of 34% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent ("FTE") basis. Net interest income divided by average earning assets is referred to as the net interest margin. The difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities is referred to as the net interest spread.

In comparison to the first quarter of 2006, net interest income on a taxable equivalent basis increased \$1,117,000, or 17.9%. The improvement was due largely to the impact of the Community First acquisition, which significantly increased the Company's interest earning assets. Average interest earning assets increased from \$605,026,000 in the first quarter of 2006 to \$714,427,000 in the recently completed quarter. First quarter 2007 interest income included a positive impact of \$134,000 related to amortization on the valuation of Community First's loans. Similarly, interest expense for the quarter was reduced by \$66,000 related to amortization on the valuation of certain Community First deposits. Beginning April 2006, the loan valuation is being amortized over fifty-two months and the deposit valuation over thirteen months. The Company's net interest margin, on a fully taxable equivalent basis, was 4.13% during the first quarter of 2007, compared to 4.14% during the same quarter of 2006.

To meet its funding needs for the Community First acquisition, the Company issued \$20,619,000 of trust preferred securities during the second quarter of 2006. These securities bear interest at a fixed rate of 6.66% for five years, after which the interest rate will vary quarterly based on changes in the ninety-day LIBOR index. The Company may repay all or a portion of the securities after five years. Interest expense associated with these securities was \$343,000 during the first quarter of 2006.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the first quarter 2007 and 2006. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

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Table 1 - Net Interest Income Analysis
For the Three Months Ended March 31, 2007 and 2006
(in thousands, except yields and rates)

| | Average Balance | | Interest Income/Expense | | Average Yield/Rate | |
|---|-------------------|-------------------|-------------------------|--------------|--------------------|-------------|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Loans: | | | | | | |
| Commercial | \$ 88,962 | \$ 70,421 | \$ 1,693 | \$ 1,238 | 7.61% | 7.03% |
| Real Estate | 444,854 | 331,522 | 8,165 | 5,508 | 7.34 | 6.65 |
| Consumer | 10,346 | 10,221 | 242 | 229 | 9.36 | 8.96 |
| Total loans | 544,162 | 412,164 | 10,100 | 6,975 | 7.42 | 6.77 |
| Securities: | | | | | | |
| Federal agencies | 82,257 | 90,141 | 857 | 807 | 4.17 | 3.58 |
| Mortgage-backed | 20,001 | 21,626 | 241 | 245 | 4.82 | 4.53 |
| State and municipal | 45,963 | 47,419 | 634 | 673 | 5.52 | 5.68 |
| Other | 8,783 | 12,372 | 129 | 154 | 5.87 | 4.98 |
| Total securities | 157,004 | 171,558 | 1,861 | 1,879 | 4.74 | 4.38 |
| Deposits in other banks | 13,261 | 21,304 | 171 | 232 | 5.16 | 4.36 |
| Total interest earning assets | 714,427 | 605,026 | 12,132 | 9,086 | 6.79 | 6.00 |
| Nonearning assets | 64,431 | 26,908 | | | | |
| Total assets | \$ 778,858 | \$ 631,934 | | | | |
| Deposits: | | | | | | |
| Demand | \$ 110,115 | \$ 97,050 | \$ 424 | \$ 303 | 1.54% | 1.25% |
| Money market | 52,140 | 41,414 | 349 | 221 | 2.68 | 2.13 |
| Savings | 68,927 | 78,256 | 235 | 187 | 1.36 | 0.96 |
| Time | 262,624 | 196,013 | 2,775 | 1,596 | 4.23 | 3.26 |
| Total deposits | 493,806 | 412,733 | 3,783 | 2,307 | 3.06 | 2.24 |
| Repurchase agreements | 46,254 | 39,941 | 426 | 309 | 3.68 | 3.09 |
| Other borrowings | 36,720 | 17,230 | 549 | 213 | 5.98 | 4.94 |
| Total interest bearing liabilities | 576,780 | 469,904 | 4,758 | 2,829 | 3.30 | 2.40 |
| Noninterest bearing demand deposits | 101,011 | 85,025 | | | | |
| Other liabilities | 5,735 | 3,105 | | | | |
| Shareholders' equity | 95,332 | 73,900 | | | | |
| Total liabilities and shareholders' equity | \$ 778,858 | \$ 631,934 | | | | |

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| | | |
|--|----------|----------|
| Interest rate spread | 3.49% | 3.60% |
| Net interest margin | 4.13% | 4.14% |
| Net interest income (taxable equivalent basis) | 7,374 | 6,257 |
| Less: Taxable equivalent adjustment | 234 | 238 |
| Net interest income | \$ 7,140 | \$ 6,019 |

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Allowance and Provision for Loan Losses

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

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

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

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

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

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, management cannot provide assurance that, in any particular period, the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time, including economic conditions, industry trends and ongoing internal and external examination processes.

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

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

The provision for loan losses increased from \$126,000 in the first quarter of 2006 to \$303,000 in the first quarter of 2007.

The allowance for loan losses was \$7,590,000 at March 31, 2007, an increase of 4.5% over the \$7,264,000 recorded at December 31, 2006. The allowance represented 1.40% of loans at March 31, 2007, in comparison to 1.34% at December 31, 2006. Management believes the allowance for loan losses is adequate to absorb losses inherent in the Company's loan portfolio at March 31, 2007. More information regarding loan quality is provided in the "Asset Quality, Credit Risk Management, and Nonperforming Assets" section.

Noninterest Income

Noninterest income rose 16.4% from \$1,901,000 in the first quarter of 2006 to \$2,212,000 in the first quarter of 2007. The increase was due in large part to growth in trust fees, increases in deposit account service charge income and mortgage banking revenue, and income from bank owned life insurance acquired from Community First.

Fees from the management of trusts, estates, and asset management accounts totaled \$879,000 in the first quarter of 2007, up 16.4% from \$755,000 for the same period in 2006. These increases were due primarily to new account activity and fee structure changes.

Service charges on deposit accounts were \$622,000, up from \$571,000 for the first quarter of 2006, due primarily to the acquisition of Community First.

Mortgage banking income represents fees from originating, selling, and brokering residential mortgage loans. Mortgage banking income was \$190,000 for the first quarter of 2007, an increase of 42.9% from the first quarter of 2006. This increase was due to an increase in volume.

Other noninterest income increased \$95,000 in the first quarter of 2007 over the comparable quarter of 2006. This increase was due to increases in Visa check card income, wire transfer fees, check order charges, and check cashing fees. Income from bank owned life insurance of \$33,000 as well as an increase in dividends from the Company's ownership in Virginia Bankers Insurance and Virginia Title Center contributed to the increase in noninterest income.

Noninterest Expense

Noninterest expense increased \$787,000 from the first quarter of 2006 to 2007, due in large part to the impact of the Community First acquisition.

Salaries increased \$406,000 or 20.5% in the first quarter of 2007 as compared to the same period in 2006. This was due largely to the acquisition of Community First.

Occupancy and equipment expense increased \$183,000 in the first quarter of 2007 as compared to the same period in 2006. This increase is primarily due to the additional four branch offices of Community First obtained in the acquisition.

Bank franchise tax expense increased \$28,000 in the first quarter of 2007 in comparison to the same quarter of 2006. Core deposit intangible amortization expense also increased during the first quarter of 2007 by \$55,000 over the comparable period of 2006, both of which were related to the Community First merger.

Other noninterest expense increased \$116,000 in the first quarter of 2007 compared to the same quarter of 2006. This increase is due primarily to the general expenses associated with servicing the customer base obtained with the Community First merger.

Income Tax Provision

The effective tax rate for the first quarter of 2007 was 30.3% compared to 29.5% for the same period of 2006. The effective tax rate is lower than the statutory rate primarily due to the effect of the Company's ownership of tax-exempt state and municipal securities.

Index**FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL****Securities**

Average securities decreased \$14,554,000, or 8.5% during the first quarter of 2007, as compared to the same period in 2006. This decrease was due in part to the increase in average loans of \$132,000,000.

Loans

Average loans were \$544,162,000 during the first quarter of 2007, compared with \$412,164,000 in the first quarter of 2006. The increase in loans is primarily the result of the Community First acquisition.

Asset Quality, Credit Risk Management, and Nonperforming Assets

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

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

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented .68% of total loans at March 31, 2007, and .63% at December 31, 2006.

The following table summarizes nonperforming assets (in thousands):

| | March 31, 2007 | December 31, 2006 |
|--------------------------------|-------------------|----------------------|
| Loans 90 days or more past due | \$ - | \$ - |
| Nonaccrual loans | 3,689 | 3,425 |
| Nonperforming loans | 3,689 | 3,425 |
| Foreclosed real estate | 99 | 99 |
| Nonperforming assets | \$ 3,788 | \$ 3,524 |

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

Liquidity

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

Management monitors and plans the liquidity position for future periods. Liquidity strategies are implemented and monitored by ALCO. The Committee uses a simulation and budget model to manage the future liquidity needs of the Company.

The Company's net liquid assets, which includes cash and due from banks and unpledged securities available for sale, less the Company's reserve requirement, to liabilities ratio was 13.9% at March 31, 2007 and 12.6% at December 31, 2006. Both of these ratios reflect adequate liquidity for the respective periods.

The Company has a line of credit with the FHLB equal to 30% of the Company's assets. This equated to a line of credit in the amount of \$236,030,000 at March 31, 2007. Borrowings under the line were \$15,050,000 at March 31, 2007. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB.

The Company had fixed-rate term borrowing contracts with the FHLB as of March 31, 2007, with the following final maturities:

| Amount | Expiration Date |
|-----------|-----------------|
| \$ 1,000 | July 2007 |
| 3,000 | June 2008 |
| 5,000 | August 2008 |
| 5,000 | April 2009 |
| 1,050 | March 2014 |
| \$ 15,050 | |

The Company also has federal funds lines of credit established with two other banks in the amounts of \$15,000,000 and \$5,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at March 31, 2007.

IndexDeposits

Average deposits were \$594,817,000 during the first quarter of 2007, up 19.5% from \$497,758,000 during the same quarter of 2006. The increase in deposits was primarily the result of the Community First acquisition.

Off-Balance-Sheet Activities

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

| | March 31, 2007 | December 31, 2006 |
|-------------------------------------|----------------------|----------------------|
| Commitments to extend credit | \$ 155,442 | \$ 155,038 |
| Standby letters of credit | 2,858 | 3,125 |
| Mortgage loan rate-lock commitments | 1,313 | 2,246 |

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

Shareholders' Equity

In the first quarter of 2007, the Company declared and paid a quarterly cash dividend of \$.22 per share.

On August 15, 2006, the Company's board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 125,000 shares of the Company's common stock between August 16, 2006 and August 21, 2007. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Company. Since December 31, 2006, 11,600 shares were repurchased.

One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Average shareholders' equity was 12.24% of average assets at March 31, 2007, and 11.69% at March 31, 2006. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios for financial institutions. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and

off-balance-sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance-sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholders' equity, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At March 31, 2007, the Company's Tier I and total capital ratios were 16.45% and 17.74%, respectively. At December 31, 2006, these ratios were 16.18% and 17.45%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratios were 12.37% and 12.15% at March 31, 2007 and December 31, 2006, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

As mandated by bank regulations, the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." These regulations require the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier I risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, and leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of March 31, 2007, that the Company met the requirements to be considered "well capitalized."

Impact of Inflation and Changing Prices

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Management

Effectively managing market risk is essential to achieving the Company's financial objectives. Market risk reflects the risk of economic loss resulting from adverse changes in interest rates and market prices. The Company is generally not subject to currency exchange risk or commodity price risk.

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

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

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

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

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

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934), as amended (the "Exchange Act") as of March 31, 2007. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure

that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended March 31, 2007 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

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PART II

OTHER INFORMATION

Item:

1. Legal Proceedings

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

1A. Risk Factors

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

2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases made for the Quarter Ended March 31, 2007

| Dates | Total Number of Shares Purchased | Average Price Paid Per share | Total Number of Shares Purchased as Part of Publicly Announced Program | Maximum Number of Shares that May Yet Be Purchased Under the Program |
|------------------|---|---------------------------------------|---|---|
| January 1-31 | 8,100 | \$ 23.40 | 8,100 | 112,000 |
| February 1-28 | - | - | - | - |
| March 1-31 | 3,500 | 22.56 | 3,500 | 108,500 |

On August 15, 2006, the Company's board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 125,000 shares of the Company's common stock between August 16, 2006 and August 21, 2007. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Company.

3. Defaults Upon Senior Securities
None4. Submission of Matters to a Vote of Security Holders
None

5. Other Information

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

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|------|-----|---|
| | 6. | Exhibits |
| | 11. | Refer to EPS calculation in the Notes to Financial Statements |
| 31.1 | | Section 302 Certification of Charles H. Majors, President and Chief Executive Officer |
| 31.2 | | Section 302 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer |
| 32.1 | | Section 906 Certification of Charles H. Majors, President and Chief Executive Officer |
| 32.2 | | Section 906 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer |

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.

| | |
|--------------------|---------------------------------------|
| | /s/ Charles H. Majors |
| | Charles H. Majors |
| Date - May 9, 2007 | President and Chief Executive Officer |

| | |
|--------------------|--|
| | /s/ Neal A. Petrovich |
| | Neal A. Petrovich |
| Date - May 9, 2007 | Senior Vice President and Chief Financial Officer |

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