

AMERICAN NATIONAL BANKSHARES INC
Form 10-K
March 14, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

or

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

54-1284688

(State or other jurisdiction of incorporation
organization)

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

628 Main Street, Danville, VA

24541

(Address of principal executive offices)

(Zip Code)

434-792-5111

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Exchange on Which Registered |
|-----------------------------|---|
| Common Stock, \$1 par value | The Nasdaq Stock Market L.L.C. (Nasdaq Global Select Market) |

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting

company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant at June 30, 2007, based on the closing price, was \$120,255,792.

The number of shares of the Registrant’s Common Stock outstanding on March 7, 2008 was 6,103,085.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on April 22, 2008, are incorporated by reference in Part III of this report.

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*The information required by Item 10 is incorporated herein by reference to the information that appears under the headings “Election of Directors – Board of Directors and Committees - The Audit and Compliance Committee,” “Section 16(a) Beneficial Ownership Reporting Compliance,” “Report of the Audit and Compliance Committee,” and “Code of Conduct” in the Registrant’s Proxy Statement for the 2008 Annual Meeting of Shareholders.

Certain information required by Item 11 is incorporated herein by reference to the information that appears under the heading “Compensation Discussion and Analysis,” “Compensation Committee Interlocks and Insider Participation,” and “Compensation Committee Report” in the Registrant’s Proxy Statement for the 2008 Annual Meeting of Shareholders.

The information required by Item 12 is incorporated herein by reference to the information that appears under the headings “Security Ownership” and “Section 16(a) Beneficial Ownership Reporting Compliance” in the Registrant’s Proxy Statement for the 2008 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, “Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

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The information required by Item 13 is incorporated herein by reference to the information that appears under the heading “Related Party Transactions,” and “Election of Directors – Board Independence” in the Registrant’s Proxy Statement for the 2008 Annual Meeting of Shareholders.

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading “Independent Public Accountants” in the Registrant’s Proxy Statement for the 2008 Annual Meeting of Shareholders.

PART I

Forward-Looking Statements

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

A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors, may affect the operations, performance, business strategy, and results of the Company. Those factors include but are not limited to the following:

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

ITEM 1 – BUSINESS

American National Bankshares Inc. is a one-bank holding company organized under the laws of the Commonwealth of Virginia in 1984. On September 1, 1984, American National Bankshares Inc. acquired all of the outstanding capital stock of American National Bank and Trust Company, a national banking association chartered in 1909 under the laws of the United States. American National Bank and Trust Company is the only banking subsidiary of American National Bankshares Inc. In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “Trust”) and a wholly owned subsidiary of American National Bankshares Inc., 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”). In April 2006, the Company finalized the acquisition of Community First and acquired 100% of its preferred and common stock through a merger transaction. Community First was a bank holding company

headquartered in Lynchburg, Virginia, and through its subsidiary, Community First Bank, operated four banking offices serving the city of Lynchburg and Bedford, Nelson, and Amherst Counties. The Company entered into the merger agreement with Community First because it believed the merger to be consistent with its expansion strategy to target entry into strong markets that logically extend its existing footprint. The Company had previously opened a full service banking office in the Lynchburg area and was considering opening additional offices in that area.

The operations of the Company are conducted at twenty banking offices and one loan production office serving Southern and Central Virginia and the northern portion of Central North Carolina. American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-three ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking.

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Competition and Markets

Vigorous competition exists in the Company's service area. The Company competes not only with national, regional, and community banks, but also with many other types of financial institutions, including without limitation, savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies. The Company has the largest deposit market share in the City of Danville, as well as in the City of Danville and Pittsylvania County, combined.

The Southern 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.

Supervision and Regulation

The Company is extensively regulated under both federal and state law. The following information describes certain aspects of that regulation applicable to the Company and does not purport to be complete. Proposals to change the laws and regulations governing the banking industry are frequently raised in Congress, in state legislatures, and before the various bank regulatory agencies. The likelihood and timing of any changes and the impact such changes might have on the Company are impossible to determine with any certainty. A change in applicable laws or regulations, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material impact on the business, operations, and earnings of the Company.

American National Bankshares Inc.

American National Bankshares Inc. is qualified as a bank holding company ("BHC") within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). As a bank holding company, American National Bankshares Inc. is required to file various reports and additional information with the FRB and is also subject to examinations by the FRB.

The BHC Act prohibits, with certain exceptions, a BHC from acquiring beneficial ownership or control of more than 5% of the voting shares of any company, including a bank, without the FRB's prior approval and from engaging in any activity other than those of banking, managing or controlling banks or other subsidiaries authorized under the BHC Act, or furnishing services to or performing services for its subsidiaries. Among the permitted activities is the ownership of shares of any company the activities of which the FRB determines to be so closely related to banking or managing or controlling banks as to be proper incident thereto.

Under FRB policy, a BHC is expected to serve as a source of financial and managerial strength to its subsidiary banks and to commit resources to support those banks. This support may be required at times when the BHC may not have the resources to provide it. Under this policy, a BHC is expected to stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial adversity and to maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.

Under the Gramm-Leach-Bliley Act, a BHC may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional BHC's. In order to qualify for the election, all of the depository institution subsidiaries of the BHC must be well capitalized, well managed, and have achieved a rating of "satisfactory" or better under the Community Reinvestment Act (the "CRA"). Financial holding companies are permitted to engage in activities that are "financial in nature" or incidental or complementary thereto as

determined by the FRB. The Gramm-Leach-Bliley Act identifies several activities as “financial in nature,” including insurance underwriting and sales, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. American National Bankshares Inc. has not elected to become a financial holding company.

American National Bank and Trust Company

American National Bank and Trust Company is a federally chartered national bank and is a member of the Federal Reserve System. It is subject to federal regulation by the Office of the Comptroller of the Currency (the “OCC”), the FRB, and the Federal Deposit Insurance Corporation (“FDIC”).

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Depository institutions, including American National Bank and Trust Company, are subject to extensive federal and state regulations that significantly affect their business and activities. Regulatory bodies have broad authority to implement standards and initiate proceedings designed to prohibit deposit institutions from engaging in unsafe and unsound banking practices. The standards relate generally to operations and management, asset quality, interest rate exposure, and capital. The agencies are authorized to take action against institutions that fail to meet such standards.

As with other financial institutions, the earnings of American National Bank and Trust Company are affected by general economic conditions and by the monetary policies of the FRB. The FRB exerts a substantial influence on interest rates and credit conditions, primarily through open market operations in U.S. Government securities, setting the reserve requirements of member banks, and establishing the discount rate on member bank borrowings. The policies of the FRB have a direct impact on loan and deposit growth and the interest rates charged and paid thereon. They also impact the source and cost of funds and the rates of return on investments. Changes in the FRB's monetary policies have had a significant impact on the operating results of American National Bank and Trust Company and other financial institutions and are expected to continue to do so in the future; however, the exact impact of such conditions and policies upon the future business and earnings cannot accurately be predicted.

Dividend Restrictions and Capital Requirements

For information regarding the limitation on bank dividends and risk-based capital requirements, refer to Note 18 of the consolidated financial statements. Additional information may be found in the Shareholder's Equity section of Management's Discussion and Analysis of Financial Condition and Results of Operations.

FDIC Insurance

American National Bank and Trust Company's deposits are insured up to \$100,000 per insured depositor by the Deposit Insurance Fund of the FDIC. Under federal law, deposits and certain claims for administrative expenses and employee compensation against insured depository institutions are afforded a priority over other general unsecured claims against such an institution, including federal funds and letters of credit, in the liquidation or other resolution of such an institution by any receiver appointed by regulatory authorities. Such priority creditors would include the FDIC.

In February 2006, the Federal Deposit Insurance Reform Act of 2005 was adopted by Congress. This legislation increased FDIC coverage for retirement accounts to \$250,000 and indexed insurance levels for inflation.

The Federal Deposit Insurance Corporation Improvement Act

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the federal banking agencies possess broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," as defined by the law. Under regulations established by the federal banking agencies a "well capitalized" institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10%, and a leverage ratio of at least 5%, and not be subject to a capital directive order. An "adequately capitalized" institution must have a Tier 1 capital ratio of at least 4%, a total capital ratio of at least 8%, and a leverage ratio of at least 4%, or 3% in some cases. Management believes, as of December 31, 2007 and 2006, that the Company met the requirements for being classified as "well capitalized."

As required by FDICIA, the federal banking agencies also have adopted guidelines prescribing safety and soundness standards relating to, among other things, internal controls and information systems, internal audit systems, loan documentation, credit underwriting, and interest rate exposure. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the agencies

adopted regulations that authorize, but do not require, an institution which has been notified that it is not in compliance with safety and soundness standard to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the prompt corrective action provisions described above.

Community Reinvestment and Consumer Protection Laws

In connection with its lending activities, the Company is subject to a number of federal laws designed to protect borrowers and promote lending to various sectors of the economy and population. These include the Equal Credit Opportunity Act, the Truth-in-Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Community Reinvestment Act.

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The CRA requires the appropriate federal banking agency, in connection with its examination of a bank, to assess the bank's record in meeting the credit needs of the communities served by the bank, including low and moderate income neighborhoods. Furthermore, such assessment is also required of banks that have applied, among other things, to merge or consolidate with or acquire the assets or assume the liabilities of an insured depository institution, or to open or relocate a branch. In the case of a BHC applying for approval to acquire a bank or BHC, the record of each subsidiary bank of the applicant BHC is subject to assessment in considering the application. Under the CRA, institutions are assigned a rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance." The Company was rated "outstanding" in its most recent CRA evaluation.

Anti-Money Laundering Legislation

The Company is subject to the Bank Secrecy Act and other anti-money laundering laws and regulations, including the USA Patriot Act of 2001. Among other things, these laws and regulations require the Company to take steps to prevent the use of the Company for facilitating the flow of illegal or illicit money, to report large currency transactions, and to file suspicious activity reports. The Company is also required to carry out a comprehensive anti-money laundering compliance program. Violations can result in substantial civil and criminal sanctions. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and BHC acquisitions.

Employees

At December 31, 2007, the Company employed 263 full-time equivalent persons. The relationship with employees is considered to be good.

Internet Access to Company Documents

The Company provides access to its Securities and Exchange Commission (the "SEC") filings through a link on the Investor Relations page of the Company's website 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 Officers of the Registrant

The following lists, as of December 31, 2007, the named executive officers of the registrant, their ages, and their positions.

| Name | Age | Position |
|-------------------|-----|---|
| Charles H. Majors | 62 | President and Chief Executive Officer of the Company. |
| R. Helm Dobbins | 56 | Senior Vice President of American National Bankshares Inc.; Executive Vice President and Chief Credit Officer of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President and Chief Credit Officer of American National Bank and Trust Company since June 2003; Executive Vice President and Chief Credit Officer of Citizens Bank and Trust Co. from 1998 to 2003. |

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Jeffrey V.47 Senior Vice President of American National Bankshares Inc.; Executive Vice President and Chief
Haley Operating Officer of American National Bank and Trust Company since November 2005; prior thereto,
Senior Vice President and Chief Administrative Officer of American National Bank and Trust Company.

Neal A. 45 Senior Vice President, Chief Financial Officer, Treasurer and Secretary of American National
Petrovich Bankshares Inc.; Executive Vice President, Chief Financial Officer, and Cashier of American National
Bank and Trust Company since November 2005; prior thereto, Senior Vice President, Chief Financial
Officer and Cashier of American National Bank and Trust Company since May 2004; Senior Vice
President of SouthTrust Bank from 2002 to May 2004; Executive Vice President and Chief Financial
Officer of Bank of Tidewater from 1995 to 2002.

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ITEM 1A – RISK FACTORS

The Company's business is subject to interest rate risk and variations in interest rates may negatively affect financial performance.

Changes in the interest rate environment may reduce the Company's profits. It is expected that the Company will continue to realize income from the differential or "spread" between the interest earned on loans, securities, and other interest earning assets, and interest paid on deposits, borrowings and other interest bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest earning assets and interest bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and rising interest rates generally are associated with a lower volume of loan originations. Management cannot ensure that it can minimize the Company's interest rate risk. While an increase in the general level of interest rates may increase the loan yield and the net interest margin, it may adversely affect the ability of certain borrowers with variable rate loans to pay the interest and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect the net interest spread, asset quality, loan origination volume, and overall profitability of the Company.

The Company faces strong competition from financial services companies and other companies that offer banking services which could negatively affect the Company's business.

Increased competition may result in reduced business for the Company. Ultimately, the Company may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that the Company offers in its service area. These competitors include national, regional, and community banks. The Company also faces competition from many other types of financial institutions, including without limitation, savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies. In particular, competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs and conduct extensive promotional and advertising campaigns.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain loans and deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. If the Company is unable to attract and retain banking customers, it may be unable to continue to grow loan and deposit portfolios and its results of operations and financial condition may otherwise be adversely affected.

Changes in economic conditions could materially and negatively affect the Company's business.

The Company's business is directly impacted by factors such as economic, political, and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies, and inflation, all of which are beyond the Company's control. A deterioration in economic conditions, whether caused by national or local concerns, especially within the Company's market area, could result in the following consequences, any of which could hurt business materially: loan delinquencies may increase; problem assets and foreclosures may increase; demand for products and services may decrease; low cost or noninterest bearing deposits may decrease; and collateral for loans, especially real estate, may decline in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral associated with existing loans.

Trust and Investment Services fee revenue is largely dependent on the fair market value of assets under care and on trading volumes in the brokerage business. General economic conditions and their subsequent effect on the securities

markets tend to act in correlation. When general economic conditions deteriorate, consumer and corporate confidence in securities markets erodes, and Trust and Investment Service revenues are negatively impacted as asset values and trading volumes decrease.

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A downturn in the real estate market could materially and negatively affect the Company's business.

A downturn in the real estate market could negatively affect the Company's business because significant portions (approximately 82% as of December 31, 2007) of its loans are secured by real estate. The ability to recover on defaulted loans by selling the real estate collateral could then be diminished and the Company would be more likely to suffer losses on defaulted loans.

Substantially all of the Company's real property collateral is located in its market area. If there is a significant decline in real estate values, especially in our market area, the collateral for loans would provide less security. Real estate values could be affected by, among other things, an economic slowdown and an increase in interest rates.

The Company is dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect the Company's prospects.

The Company currently depends heavily on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company's success also depends in part on the ability to attract and retain additional qualified management personnel. Competition for such personnel is strong in the banking industry and the Company may not be successful in attracting or retaining the personnel it requires.

The Company is subject to extensive regulation which could adversely affect its business.

The Company's operations are subject to extensive regulation by federal, state, and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of the Company's operations. Because the Company's business is highly regulated, the laws, rules, and regulations applicable to it are subject to regular change. There are currently proposed laws, rules, and regulations that, if adopted, would impact the Company's operations. There can be no assurance that these proposed laws, rules, and regulations, or any other laws, rules, or regulations, will not be adopted in the future, which could (i) make compliance much more difficult and expensive, (ii) restrict the ability to originate, broker or sell loans, or accept certain deposits, (iii) further limit or restrict the amount of commissions, interest, or other charges earned on loans originated by the Company, or (iv) otherwise adversely affect the Company's business or prospects for business.

The primary source of the Company's income from which it pays dividends is the receipt of dividends from its subsidiary bank.

The availability of dividends from the Company is limited by various statutes and regulations. It is possible, depending upon the financial condition of the subsidiary bank and other factors, that the Office of the Comptroller of the Currency could assert that payment of dividends or other payments is an unsafe or unsound practice. In the event American National Bank and Trust Company was unable to pay dividends to American National Bankshares Inc., the holding company would likely have to reduce or stop paying common stock dividends. The Company's failure to pay dividends on its common stock could have a material adverse effect on the market price of the common stock.

A limited trading market exists for the Company's common stock which could lead to price volatility.

The Company's common stock is approved for quotation on the NASDAQ Global Select Market, but the trading volume has generally been modest. The limited trading market for the common stock may cause fluctuations in the stock's market value to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market. In addition, even if a more active market in the Company's common stock develops, management cannot ensure that such a market will continue or that shareholders will be able to sell their shares.

The allowance for loan losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, an allowance for loan losses is maintained to provide for loan losses. The allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect operating results. The allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating, and other conditions, including changes in interest rates that may be beyond control, and these losses may exceed current estimates. Federal regulatory agencies, as an integral part of their examination process, review the Company's loans and allowance for loan losses. While management believes that the allowance for loan losses is adequate to cover current losses, it cannot make assurances that it will not further increase the allowance for loan losses or that regulators will not require it to increase this allowance. Either of these occurrences could adversely affect earnings.

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The allowance for loan losses requires management to make significant estimates that affect the financial statements. Due to the inherent nature of this estimate, management cannot provide assurance that it will not significantly increase the allowance for loan losses which could materially and adversely affect earnings.

The Company is exposed to operational risk.

The Company is exposed to many types of operational risks, including reputation, legal, and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Negative public opinion can result from the actual or alleged conduct in any number of activities, including lending practices, corporate governance, and acquisitions, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect the Company's ability to attract and retain customers and can expose it to litigation and regulatory action.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process its transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company may also be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

Changes in accounting standards could impact reported earnings.

From time to time there are changes in the financial accounting and reporting standards that govern the preparation of the Company's financial statements. These changes can materially impact how the Company records and reports its financial condition and results of operations. In some instances, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of prior period financial statements.

The Company's information systems may experience an interruption or breach in security.

The Company relies heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in the Company's relationship management, general ledger, deposit, loan, and other systems. While the Company has policies and procedures designed to prevent or limit the effect of such failure, interruption, or security breach, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. Any such occurrences could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the company to civil litigation and possible financial liability, any of which could have a material adverse affect on the Company's financial condition and results of operations.

ITEM 2 – PROPERTIES

As of December 31, 2007, the Company maintained twenty banking offices located in Danville, Pittsylvania County, Martinsville, Henry County, Halifax County, Lynchburg, Bedford County, Campbell County, and Nelson County in Virginia and Caswell County in North Carolina. The Company also operates a loan production office in Greensboro, North Carolina.

The principal executive offices of the Company are located at 628 Main Street in the business district of Danville, Virginia. This building, owned by the Company, was originally constructed in 1973 and has three floors totaling approximately 27,000 square feet.

The Company owns a building located at 103 Tower Drive in Danville, Virginia. This three-story facility serves as a retail banking office and houses certain of the Company's finance, administrative, and operations staff.

The Company owns an office building on 203 Ridge Street, Danville, Virginia, which is leased to Bankers Insurance, LLC. The Company has a minority ownership interest in Bankers Insurance, LLC.

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The Company owns eleven other retail office locations for a total of fourteen owned buildings. There are no mortgages or liens against any of the properties owned by the Company. The Company operates twenty-three Automated Teller Machines (“ATMs”) on owned or leased facilities. The Company leases seven of the retail office locations and a storage warehouse.

ITEM 3 – LEGAL PROCEEDINGS

There are no material pending legal proceedings to which the Company is a party or to which the property of the Company is subject.

ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders of the Company through a solicitation of proxies or otherwise.

PART II

ITEM 5 – MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company’s common stock is traded on the NASDAQ Global Select Market under the symbol “AMNB.” At December 31, 2007, the Company had 1,694 shareholders of record. The following table presents the high and low closing sales prices for the Company’s common stock and dividends declared for the past two years.

Market Price of the Company’s Common Stock

| 2007 | Closing Price | | Dividends |
|-------------|---------------|----------|-----------|
| | High | Low | Per Share |
| 4th quarter | \$ 22.76 | \$ 19.40 | \$ 0.23 |
| 3rd quarter | 22.96 | 20.50 | 0.23 |
| 2nd quarter | 23.08 | 22.15 | 0.23 |
| 1st quarter | 23.68 | 22.02 | 0.22 |
| | | | \$ 0.91 |

| 2006 | Closing Price | | Dividends |
|-------------|---------------|----------|-----------|
| | High | Low | Per Share |
| 4th quarter | \$ 23.87 | \$ 22.81 | \$ 0.22 |
| 3rd quarter | 24.00 | 22.45 | 0.22 |
| 2nd quarter | 24.02 | 22.50 | 0.22 |
| 1st quarter | 24.07 | 22.30 | 0.21 |
| | | | \$ 0.87 |

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The table below presents share repurchase activity during the quarter ended December 31, 2007.

| | 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 |
|------------------------|--|---------------------------------------|--|--|
| October 1-31, 2007 | 6,200 | \$ 22.66 | 6,200 | 112,200 |
| November 1-30, 2007 | 200 | 20.35 | 200 | 112,000 |
| December 1-31, 2007 | 2,300 | 20.11 | 2,300 | 109,700 |
| | 8,700 | \$ 21.93 | 8,700 | |

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Stock Option Plan

The Company maintained a stock option plan (the “Plan”) designed to attract and retain qualified personnel in key positions, provide employees with a proprietary interest in the Company as an incentive to contribute to the success of the Company, and reward employees for outstanding performance and the attainment of targeted goals. The Plan was approved by the shareholders at the 1997 Annual Meeting, and options were eligible to be granted under the Plan through December 31, 2006. The Plan provided for the granting of incentive stock options intended to comply with the requirements of Section 422 of the Internal Revenue Code of 1986 (“incentive stock options”), as well as non-qualified stock options.

The Plan is administered by a committee of the Board of Directors of the Company comprised of independent Directors. Under the Plan, the committee determines which employees will be granted options, whether such options will be incentive or non-qualified options, the number of shares subject to each option, whether such options may be exercised by delivering other shares of common stock, and when such options became exercisable. In general, the per share exercise price of an incentive stock option must be at least equal to the fair market value of a share of common stock on the date the option is granted.

Stock options became vested and exercisable in the manner specified by the committee. Each stock option or portion thereof shall be exercisable at any time on or after it vests and is exercisable until ten years after its date of grant. There were no stock options awarded in 2007.

| | December 31, 2007 | | |
|--|---|--|--|
| | Number of Shares to be Issued Upon Exercise of Outstanding Options | Weighted-Average Per Share Exercise Price of Outstanding Options | Number of Shares Remaining Available for Future Issuance Under Stock Option Plan |
| Equity compensation plans approved by shareholders | 174,871 | \$ 21.15 | - |
| Equity compensation plans not approved by shareholders | - | - | - |
| Total | 174,871 | \$ 21.15 | - |

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Comparative Stock Performance

The following graph compares the Company's cumulative total return to its shareholders with the returns of three indexes for the five-year period ended December 31, 2007. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2002. The indexes are the NASDAQ Composite Index; the SNL Bank \$500 Million-\$1Billion Index, which includes bank holding companies with assets of \$500 million to \$1 billion and is published by SNL Financial, LC; and the Independent Bank Index, which is provided by Carson Medlin Company and consists of 27 independent community banks located in the southeastern states of Alabama, Florida, Georgia, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.

| Index | Period Ending | | | | | |
|-----------------------------------|---------------|----------|----------|----------|----------|----------|
| | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 |
| American National Bankshares Inc. | \$100.00 | \$103.32 | \$99.16 | \$98.63 | \$102.66 | \$91.66 |
| NASDAQ Composite | 100.00 | 150.01 | 162.89 | 165.13 | 180.85 | 198.60 |
| SNL Bank \$500M-\$1B | 100.00 | 144.19 | 163.41 | 170.41 | 193.81 | 155.31 |
| Independent Bank Index | 100.00 | 137.00 | 156.00 | 167.00 | 194.00 | 147.00 |

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ITEM 6 - Selected Financial Data

The following table sets forth selected financial data for the Company for the last five years:

(in thousands, except per share amounts and ratios)

| | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|-----------|-----------|-----------|-----------|-----------|
| Results of Operations: | | | | | |
| Interest income | \$ 48,597 | \$ 45,070 | \$ 32,479 | \$ 30,120 | \$ 32,178 |
| Interest expense | 19,370 | 16,661 | 8,740 | 7,479 | 9,391 |
| Net interest income | 29,227 | 28,409 | 23,739 | 22,641 | 22,787 |
| Provision for loan losses | 403 | 58 | 465 | 3,095 | 920 |
| Noninterest income | 8,822 | 8,458 | 7,896 | 6,510 | 6,671 |
| Noninterest expense | 21,326 | 20,264 | 17,079 | 15,011 | 15,111 |
| Income before income tax provision | 16,320 | 16,545 | 14,091 | 11,045 | 13,427 |
| Income tax provision | 4,876 | 5,119 | 4,097 | 3,032 | 3,914 |
| Net income | \$ 11,444 | \$ 11,426 | \$ 9,994 | \$ 8,013 | \$ 9,513 |
| Period-end Balances: | | | | | |
| Securities | \$157,149 | \$162,621 | \$165,629 | \$188,163 | \$207,479 |
| Loans, net of unearned income | 551,391 | 542,228 | 417,087 | 407,269 | 406,245 |
| Deposits | 581,221 | 608,528 | 491,651 | 485,272 | 501,688 |
| Assets | 772,288 | 777,720 | 623,503 | 619,065 | 644,302 |
| Shareholders' equity | 101,511 | 94,992 | 73,419 | 71,000 | 71,931 |
| Shareholders' equity - tangible (a) | 76,591 | 69,695 | 73,287 | 70,516 | 70,997 |
| Per Share Information: | | | | | |
| Earnings - basic | \$ 1.86 | \$ 1.91 | \$ 1.83 | \$ 1.43 | \$ 1.67 |
| Earnings - diluted | 1.86 | 1.90 | 1.81 | 1.42 | 1.65 |
| Dividends | 0.91 | 0.87 | 0.83 | 0.79 | 0.75 |
| Book value | 16.59 | 15.42 | 13.49 | 12.86 | 12.71 |
| Book value - tangible (a) | 12.52 | 11.31 | 13.47 | 12.77 | 12.54 |
| Ratios: | | | | | |
| Return on average assets | 1.48 % | 1.51% | 1.61% | 1.26% | 1.52% |
| Return on average shareholders' equity | 11.69 | 12.72 | 13.95 | 11.15 | 13.52 |
| Return on average tangible equity (b) | 16.09 | 16.60 | 14.35 | 11.72 | 14.21 |
| Net interest margin - taxable equivalent | 4.24 | 4.20 | 4.17 | 3.90 | 3.98 |
| Average shareholders' equity / average assets | 12.65 | 11.85 | 11.57 | 11.34 | 11.27 |
| Dividend payout ratio | 48.82 | 45.58 | 45.39 | 55.13 | 44.96 |
| Net charge-offs to average loans | 0.05 | 0.10 | 0.56 | 0.10 | 0.30 |

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| | | | | | |
|---|------|------|------|------|------|
| Allowance for loan losses to period-end loans | 1.34 | 1.34 | 1.46 | 1.96 | 1.30 |
| Nonperforming assets to total assets | 0.42 | 0.45 | 0.72 | 1.35 | 0.56 |

(a) - Excludes goodwill and other intangible assets

(b) - Excludes amortization expense, net of tax, of intangible assets

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ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on significant changes in the financial condition and results of operations of the Company during the past three years. The discussion and analysis are intended supplement and highlight information contained in the accompanying Consolidated Financial Statements and the selected financial data presented elsewhere in this Annual Report on Form 10-K. Financial institutions acquired by the Company during the past three years and accounted for as purchases are reflected in the financial position and results of operations of the Company since the date of their acquisition.

RECLASSIFICATION

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

CRITICAL ACCOUNTING POLICIES

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

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

Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

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

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

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

Goodwill 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 2007 indicated that goodwill is not impaired and is properly recorded in the financial statements.

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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.

EXECUTIVE OVERVIEW

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

American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-three ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking.

Additional information is available on the Company’s website at www.amnb.com. The shares of American National Bankshares Inc. are traded on the NASDAQ Global Select Market under the symbol “AMNB.”

The Company’s mission, vision, and guiding principles are as follows:

Mission

We provide quality financial services with exceptional customer service.

Vision

We will enhance the value of our shareholders’ investment by being our communities’ preferred provider of relationship-based financial services.

Guiding Principles

To achieve our vision and carry out our mission, we:

- operate a sound, efficient, and highly profitable company,
- identify and respond to our internal and external customers’ needs and expectations in an ever changing financial services environment,
- provide quality sales and quality service to our customers,
- produce profitable growth,
- provide an attractive return for our shareholders,
- furnish positive leadership for the well-being of all communities we serve,
- continuously develop a challenging and rewarding work environment for our employees, and
- conduct our work with integrity and professionalism.

RESULTS OF OPERATIONS

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.

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Net interest income increased \$757,000, or 2.6% from 2006 to 2007, following a \$4,670,000, or 19.7% increase in 2006 from 2005 levels. These increases were primarily due to balance sheet growth including the acquisition of Community First Financial Corporation in April 2006. Additionally, purchase accounting adjustments from the Community First acquisition had a positive impact on net interest income in 2007 and 2006. Payoffs of acquired loans accounted for under American Institute of Certified Public Accountants Statement of Position 03-3 resulted in \$571,000 of interest income in 2007. Interest income related to the valuation of other loans acquired from Community First was \$536,000 and \$402,000 in 2007 and 2006, respectively. Similarly, interest expense related to the valuation of acquired deposits was \$88,000 and \$197,000 in 2007 and 2006, respectively. The net interest margin improved slightly from 4.20% in 2006 to 4.24% in 2007, after increasing from 4.17% in 2005, due generally to the fact that loans comprised an increasing portion of earning assets compared to lower-yielding investment securities and to the effect of the purchase accounting adjustments discussed above.

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. Interest expense associated with these securities was \$1,373,000 for 2007 and \$1,007,000 for 2006.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the years 2005 through 2007. 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.

Table 1 - Net Interest Income Analysis

(in thousands, except yields and rates)

| | Average Balance | | | Interest Income/Expense | | | Average Yield/Rate | | |
|-------------------------------|-----------------|-----------|-----------|-------------------------|----------|----------|--------------------|-------|-------|
| | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 |
| Loans: | | | | | | | | | |
| Commercial | \$ 89,673 | \$ 84,676 | \$ 74,202 | \$ 6,980 | \$ 6,481 | \$ 4,627 | 7.78% | 7.65% | 6.24% |
| Real Estate | 449,683 | 416,530 | 327,888 | 33,621 | 29,813 | 20,155 | 7.48 | 7.16 | 6.15 |
| Consumer | 10,420 | 12,287 | 12,490 | 975 | 1,152 | 1,132 | 9.36 | 9.38 | 9.06 |
| Total loans | 549,776 | 513,493 | 414,580 | 41,576 | 37,446 | 25,914 | 7.56 | 7.29 | 6.25 |
| Securities: | | | | | | | | | |
| Federal agencies | 68,521 | 94,589 | 77,609 | 3,032 | 3,745 | 2,414 | 4.42 | 3.96 | 3.11 |
| Mortgage-backed | 25,406 | 21,197 | 25,614 | 1,255 | 988 | 1,099 | 4.94 | 4.66 | 4.29 |
| State and municipal | 46,069 | 46,735 | 51,943 | 2,530 | 2,624 | 3,049 | 5.49 | 5.61 | 5.87 |
| Other | 7,484 | 11,059 | 15,273 | 438 | 621 | 715 | 5.85 | 5.62 | 4.68 |
| Total securities | 147,480 | 173,580 | 170,439 | 7,255 | 7,978 | 7,277 | 4.92 | 4.60 | 4.27 |
| Deposits in other banks | 13,431 | 12,922 | 9,782 | 679 | 620 | 376 | 5.06 | 4.80 | 3.84 |
| Total interest earning assets | 710,687 | 699,995 | 594,801 | 49,510 | 46,044 | 33,567 | 6.97 | 6.58 | 5.64 |
| Nonearning assets | 62,952 | 57,807 | 24,273 | | | | | | |
| Total assets | \$773,639 | \$757,802 | \$619,074 | | | | | | |
| Deposits: | | | | | | | | | |

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| | | | | | | | | | |
|--|-----------|-----------|-----------|----------|----------|----------|-------|-------|-------|
| Demand | \$107,834 | \$105,320 | \$ 82,121 | 1,550 | 1,513 | 539 | 1.44% | 1.44% | 0.66% |
| Money market | 52,843 | 48,124 | 44,685 | 1,429 | 1,180 | 715 | 2.70 | 2.45 | 1.60 |
| Savings | 66,246 | 77,445 | 81,641 | 845 | 963 | 629 | 1.28 | 1.24 | 0.77 |
| Time | 261,286 | 255,856 | 189,467 | 11,711 | 9,693 | 5,019 | 4.48 | 3.79 | 2.65 |
| Total deposits | 488,209 | 486,745 | 397,914 | 15,535 | 13,349 | 6,902 | 3.18 | 2.74 | 1.73 |
| Repurchase agreements | 48,088 | 40,970 | 42,757 | 1,841 | 1,384 | 901 | 3.83 | 3.38 | 2.11 |
| Other borrowings | 32,591 | 33,087 | 19,474 | 1,994 | 1,928 | 937 | 6.12 | 5.83 | 4.81 |
| Total interest bearing liabilities | 568,888 | 560,802 | 460,145 | 19,370 | 16,661 | 8,740 | 3.40 | 2.97 | 1.90 |
| Noninterest bearing demand deposits | 102,003 | 102,117 | 84,670 | | | | | | |
| Other liabilities | 4,894 | 5,059 | 2,621 | | | | | | |
| Shareholders' equity | 97,854 | 89,824 | 71,638 | | | | | | |
| Total liabilities and shareholders' equity | \$773,639 | \$757,802 | \$619,074 | | | | | | |
| Interest rate spread | | | | | | | 3.57% | 3.61% | 3.74% |
| Net interest margin | | | | | | | 4.24% | 4.20% | 4.17% |
| Net interest income (taxable equivalent basis) | | | | 30,140 | 29,383 | 24,827 | | | |
| Less: Taxable equivalent adjustment | | | | 913 | 974 | 1,088 | | | |
| Net interest income | | | | \$29,227 | \$28,409 | \$23,739 | | | |

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Table 2 presents the dollar amount of changes in interest income and interest expense, and distinguishes between changes resulting from fluctuations in average balances of interest earning assets and interest bearing liabilities (volume), and changes resulting from fluctuations in average interest rates on such assets and liabilities (rate). Changes attributable to both volume and rate have been allocated proportionately.

Table 2 - Changes in Net Interest Income (Rate / Volume Analysis)
(in thousands)

| Interest income | 2007 vs. 2006 | | | 2006 vs. 2005 | | |
|-------------------------|------------------------|---------------------------|----------|------------------------|---------------------------|----------|
| | Increase (Decrease) | Change Attributable to | | Increase (Decrease) | Change Attributable to | |
| | | Rate | Volume | | Rate | Volume |
| Loans: | | | | | | |
| Commercial | \$ 499 | \$ 111 | \$ 388 | \$ 1,854 | \$ 1,144 | \$ 710 |
| Real Estate | 3,808 | 1,367 | 2,441 | 9,658 | 3,652 | 6,006 |
| Consumer | (177) | (2) | (175) | 20 | 39 | (19) |
| Total loans | 4,130 | 1,476 | 2,654 | 11,532 | 4,835 | 6,697 |
| Securities: | | | | | | |
| Federal agencies | (713) | 404 | (1,117) | 1,331 | 739 | 592 |
| Mortgage-backed | 267 | 62 | 205 | (111) | 89 | (200) |
| State and municipal | (94) | (57) | (37) | (425) | (129) | (296) |
| Other securities | (183) | 25 | (208) | (94) | 126 | (220) |
| Total securities | (723) | 434 | (1,157) | 701 | 825 | (124) |
| Deposits in other banks | 59 | 34 | 25 | 244 | 106 | 138 |
| Total interest income | 3,466 | 1,944 | 1,522 | 12,477 | 5,766 | 6,711 |
| Interest expense | | | | | | |
| Deposits: | | | | | | |
| Demand | 37 | 1 | 36 | 974 | 787 | 187 |
| Money market | 249 | 127 | 122 | 465 | 406 | 59 |
| Savings | (118) | 24 | (142) | 334 | 368 | (34) |
| Time | 2,018 | 1,808 | 210 | 4,674 | 2,576 | 2,098 |
| Total deposits | 2,186 | 1,960 | 226 | 6,447 | 4,137 | 2,310 |
| Repurchase agreements | 457 | 198 | 259 | 483 | 522 | (39) |
| Other borrowings | 66 | 95 | (29) | 991 | 230 | 761 |
| Total interest expense | 2,709 | 2,253 | 456 | 7,921 | 4,889 | 3,032 |
| Net interest income | \$ 757 | \$ (309) | \$ 1,066 | \$ 4,556 | \$ 877 | \$ 3,679 |

Noninterest Income

Noninterest income is generated from a variety of sources, including fee-based deposit services, trust and investment services, mortgage banking, and retail brokerage. Noninterest income also includes net gains or losses on sales or calls of investment securities.

Noninterest income was \$8,822,000 in 2007, up 4.3% over 2006. Increases in trust fees, mortgage banking income, brokerage, and other fee income were partially offset by decreases in deposit account service charges and by a

\$362,000 impairment charge on securities (see the Securities section of this discussion and analysis).

Noninterest income was \$8,458,000 in 2006, up 7.1% over 2005, largely due to an increase in trust fees, deposit account service charge income, mortgage banking revenue, and income from bank owned life insurance policies (“BOLI”) acquired from Community First.

Fees from the management of trusts, estates, and asset management accounts totaled \$3,578,000 in 2007, up from \$3,374,000 in 2006 and \$3,012,000 in 2005. These increases were due primarily to new account activity and fee structure changes. Market value appreciation in the securities markets also contributed to the increase as a substantial proportion of these fees are earned as a percentage of the account balances.

Service charges on deposit accounts decreased 4.6% in 2007, primarily due to reduced customer overdraft activity. Deposit account service charges increased 8.5% in 2006, primarily as a result of the acquisition of Community First.

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Other fees and commissions primarily include income generated from the Company's debit card, ATM, safe deposit box, merchant credit card, and wire transfer services. Insurance commission revenue is also included in this category. Other fees and commissions were \$786,000 in 2007, \$744,000 in 2006, and \$693,000 in 2005. The increase in both 2007 and 2006 is primarily the result of growth in debit card revenue due to increased customer debit card activity.

Mortgage banking income represents fees from originating and selling residential mortgage loans. Mortgage banking income was \$954,000 in 2007, \$709,000 in 2006, and \$665,000 in 2005. Changes in interest rates directly impact the volume of mortgage activity and, in turn, the amount of mortgage banking fee income earned.

Securities are sold from time to time for balance sheet management purposes or because an investment no longer meets the Company's policy requirements. Net gains on sales or calls of securities were \$135,000 in 2007, \$62,000 in 2006, and \$53,000 in 2005.

In December 2007, the Company recorded a \$362,000 impairment charge relating to its holdings of Federal Home Loan Mortgage Corporation ("FHLMC") and Federal National Mortgage Association ("FNMA") preferred stock. The market value of these two securities dropped significantly at the end of 2007, and any near-term recovery in value is uncertain. The Company's recorded investment in these securities, after the write-down, is \$1,346,000 at December 31, 2007. The impairment charge is recorded as a reduction of noninterest income.

Other noninterest income was \$650,000 in 2007, \$496,000 in 2006, and \$642,000 in 2005. The 2007 increase was largely the result of increased dividend revenue from the Company's investments in Bankers Insurance, LLC and Virginia Title Center, LLC. Additionally, a full year of revenue from the Company's BOLI policies increased this income category by \$34,000 in 2007. Other noninterest income growth in 2006 was impacted by increased dividend revenue from the Company's investment in the two insurance companies, and by \$100,000 of income generated from the BOLI policies acquired from Community First in April 2006. During 2005, the Company earned nonrecurring income of \$375,000 from the sale of a bankcard processor, of which the Company was a member.

Table 3 - Noninterest income
(in thousands)

| | Years Ended December 31, | | |
|-------------------------------------|--------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Trust fees | \$ 3,578 | \$ 3,374 | \$ 3,012 |
| Service charges on deposit accounts | 2,531 | 2,654 | 2,446 |
| Other fees and commissions | 786 | 744 | 693 |
| Mortgage banking income | 954 | 709 | 665 |
| Brokerage fees | 550 | 419 | 385 |
| Securities gains, net | 135 | 62 | 53 |
| Impairment of securities | (362) | - | - |
| Investment in insurance companies | 280 | 220 | 163 |
| Bank owned life insurance | 134 | 100 | - |
| Check order charges | 127 | 113 | 107 |
| | - | - | 375 |

| | | | |
|---|----------|----------|----------|
| Gain from sale of bankcard processor | | | |
| Other | 109 | 63 | (3) |
| | \$ 8,822 | \$ 8,458 | \$ 7,896 |

Noninterest Expense

Noninterest expense consists primarily of personnel, occupancy, equipment, and other expenses. Noninterest expense was \$21,326,000 in 2007, up 5.2% over 2006, due primarily to increased staff levels and a full year of expenses associated with the April 2006 Community First acquisition. Noninterest expense was \$20,264,000 in 2006, up 18.6% over 2005, due largely to the impact of the Community First acquisition.

Personnel expenses comprise over half of the Company's noninterest expense. Combined salary and benefits expense increased 3.4% in 2007 when compared to 2006. Higher staff levels and a full year of the expenses associated with Community First were partially offset by a reduction in profit sharing and incentive compensation expense. Profit sharing and incentive expense was \$287,000 in 2007, \$867,000 in 2006, and \$866,000 in 2005. Personnel expenses rose 15.3% in 2006 over 2005, due primarily to the Community First acquisition.

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Occupancy and equipment expense increased from \$2,977,000 in 2006 to \$3,527,000 in 2007, an increase of 18.5%. The increase was due in large part to a full year of expenses associated with the Community First acquisition, increased building maintenance costs, the expenses of two new branch offices, and costs related to new technology for check processing and network security. Occupancy and equipment expense increased from \$17,079,000 in 2005 to \$20,264,000 in 2006. The increase was due primarily to the acquisition of Community First.

Bank franchise tax expense was \$663,000 in 2007, compared with \$651,000 in 2006 and \$543,000 in 2005. This expense is based in large part on the level of shareholders' equity.

Core deposit intangible expense was \$377,000 in 2007, \$414,000 in 2006, and \$353,000 in 2005. The 2007 expense consists entirely of amortization of the core deposit intangible asset from the Community First acquisition; beginning April 2006, this asset is being amortized on a straight-line basis over ninety-nine months. Core deposit intangible expense in 2006 also includes amortization of the core deposit intangible asset arising from a 1996 branch purchase. The 2005 expense is comprised entirely of amortization of intangible assets related to the 1996 branch purchase as well as a 1995 branch purchase.

Other noninterest expense consists of a variety of expenses including those related to professional services, advertising and marketing, telephone systems, ATM and Internet banking services, trust services, supplies, and Federal Reserve services. Other noninterest expense totaled \$4,322,000 in 2007, \$4,196,000 in 2006, and \$3,279,000 in 2005. Other noninterest expense increased 3.0% in 2007, and was largely the result of higher trust service costs and a full year of expenses associated with the acquisition of Community First. Other noninterest expense increased \$917,000, or 28.0%, from 2005 to 2006. The increase for 2006 included \$123,000 for the establishment of a reserve for unfunded lending commitments. The Company also experienced increases in Internet banking fees, external data processing expenses, advertising and marketing costs, and telephone fees, all related primarily to the acquisition of Community First. Trust expense increased \$117,000 in 2006 related to costs of outside investment management services and increased trust operational activity.

Table 4 - Noninterest expense
(in thousands)

| | Years Ended December 31, | | |
|--------------------------------------|--------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Salaries | \$ 9,688 | \$ 9,520 | \$ 8,453 |
| Employee benefits | 2,749 | 2,506 | 1,975 |
| Occupancy and equipment | 3,527 | 2,977 | 2,476 |
| Bank franchise tax | 663 | 651 | 543 |
| Core deposit intangible amortization | 377 | 414 | 353 |
| Professional fees | 733 | 689 | 744 |
| Telephone | 395 | 361 | 290 |
| Stationery and printing supplies | 335 | 395 | 312 |
| ATM network fees | 329 | 303 | 237 |
| Advertising and marketing | 300 | 267 | 174 |
| Postage | 273 | 240 | 210 |
| | 237 | 187 | 70 |

Trust services
contracted

| | | | |
|-------------------------|-----------|-----------|-----------|
| Internet banking fees | 194 | 173 | 133 |
| Correspondent bank fees | 161 | 161 | 141 |
| Automobile | 147 | 103 | 89 |
| Contributions | 120 | 138 | 114 |
| Loan expenses | 108 | 67 | 64 |
| Courier service | 106 | 97 | 82 |
| FDIC assessment | 87 | 84 | 65 |
| Other | 797 | 931 | 554 |
| | \$ 21,326 | \$ 20,264 | \$ 17,079 |

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Income Taxes

Income taxes on 2007 earnings amounted to \$4,876,000, resulting in an effective tax rate of 29.9%, compared to 30.9% in 2006 and 29.1% in 2005. The Company was subject to a statutory, blended, Federal tax rate of 34.4% in 2007, 34.4% in 2006, and 34.3% in 2005. The major difference between the statutory rate and the effective rate results from 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.

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 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.

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 generally not subject to currency exchange risk or commodity price risk. The Company's primary market risk exposure is interest rate risk; however, market risk also includes liquidity risk. Both are discussed below.

Interest Rate Risk Management

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

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

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster or to a greater extent 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 at December 31, 2007 is asset sensitive.

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The interest rate sensitivity position at December 31, 2007 is illustrated in the following table. The carrying amounts of assets and liabilities are presented in the periods they are expected to reprice or mature.

Table 5 - Interest Rate Sensitivity Gap Analysis
December 31, 2007
(dollars in thousands)

| | Within 1 Year | > 1 Year to 3 Years | > 3 Year to 5 Years | > 5 Years | Total |
|--|---------------------|------------------------|------------------------|-------------------|-------------------|
| Interest sensitive assets: | | | | | |
| Interest bearing deposits | | | | | |
| with other banks | \$ 149 | \$ - | \$ - | \$ - | \$ 149 |
| Securities | 8,836 | 42,628 | 34,191 | 71,494 | 157,149 |
| Loans (1) | 306,781 | 128,675 | 66,019 | 51,284 | 552,759 |
| Total interest sensitive assets | 315,766 | 171,303 | 100,210 | 122,778 | 710,057 |
| Interest sensitive liabilities: | | | | | |
| Checking and savings deposits | | | | | |
| | 167,151 | - | - | - | 167,151 |
| Money market deposits | | | | | |
| | 50,254 | - | - | - | 50,254 |
| Time deposits | | | | | |
| | 203,919 | 39,313 | 21,198 | 155 | 264,585 |
| Repurchase agreements | | | | | |
| | 47,891 | - | - | - | 47,891 |
| Federal Home Loan Bank advances | | | | | |
| | 10,200 | 5,000 | - | 937 | 16,137 |
| Trust preferred capital notes | | | | | |
| | - | - | 20,619 | - | 20,619 |
| Total interest sensitive liabilities | 479,415 | 44,313 | 41,817 | 1,092 | 566,637 |
| Interest sensitivity gap | \$ (163,649) | \$ 126,990 | \$ 58,393 | \$ 121,686 | \$ 143,420 |
| Cumulative interest sensitivity gap | \$ (163,649) | \$ (36,659) | \$ 21,734 | \$ 143,420 | |
| Percentage cumulative gap to total interest sensitive assets | | | | | |
| | (23.0) % | (5.2) % | 3.1% | 20.2% | |

(1) Loans include loans held for sale and are net of unearned income.

Using the Company's simulation analysis, the following table shows the estimated impact of changes in interest rates on net interest income over a one year time horizon as of December 31, 2007. This analysis makes numerous assumptions including: modest increases in assets and liabilities, a 1.25% parallel change in interest rates in January 2008, a 1.25% parallel change in interest rates in February 2008, the Company's estimated prepayment activity on loans and mortgage-backed securities, and the Company's estimate of how interest bearing deposit accounts would reprice using current yield curves at December 31, 2007.

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Table 6 - Estimated Changes in Net Interest Income

(dollars in thousands)

| December 31, 2007 | | | |
|-------------------|-------------------------|----------|---------|
| Change in | Changes in | | |
| Interest | Net interest Income (1) | Amount | Percent |
| Rates | | | |
| Up 2.5% | | \$ 2,982 | |
| | | 10.2 | |
| | | | % |
| Up 1.25% | | 1,590 | |
| | | 5.4 | |
| Down 1.25% | | (2,192) | |
| | | (7.5) | |
| Down 2.5% | | (3,962) | |
| | | (13.5) | |

(1) Represents the difference between estimated net interest income for the next 12 months in t

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. Interest rate shifts may not be parallel.

Changes in interest rates 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 rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

Liquidity Risk Management

Liquidity is the ability of the Company to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities. Liquidity management involves maintaining the Company's ability to meet the daily cash flow requirements of its customers, whether they are borrowers requiring funds to meet their credit needs or depositors desiring to withdraw funds. Additionally, the parent company requires cash for various operating needs including dividends to shareholders, stock repurchases, the servicing of debt, and the payment of general corporate expenses. The Company manages its exposure to fluctuations in interest rates through policies approved by the ALCO and Board of Directors, both of which receive periodic reports of the Company's interest rate risk position. The Company uses a simulation and budget model to manage the future liquidity needs of the Company.

Liquidity sources include cash and amounts due from banks, deposits in other banks, loan repayments, increases in deposits, lines of credit from the FHLB, 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. Borrowings under the line were \$16,137,000 at December 31, 2007 and \$15,100,000 at December 31, 2006.

The Company had fixed-rate term borrowing contracts with the FHLB as of December 31, 2007,

| Amount | Expiration Date |
|-------------|-----------------|
| \$3,000,000 | 2008 |
| 5,000,000 | 2009 |
| 937,000 | 2014 |

The Company has federal funds lines of credit established with two other banks i

Securities

The securities portfolio generates income, plays a primary role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The composition of the Company's securities portfolio reflects the Company's investment strategy of maximizing yields, maintaining adequate liquidity, and providing a tool to manage the Company's interest rate sensitivity position.

The securities portfolio consists primarily of high quality investments for which an active market exists. Federal agency, mortgage-backed, and state and municipal securities comprise the majority of the portfolio.

In December 2007, the Company recorded a \$362,000 impairment charge relating to its holdings of FHLMC and FNMA preferred stock. The market value of these two securities dropped significantly at the end of 2007, and any near-term recovery in value is uncertain. The Company's recorded investment in these securities, after the write-down, is \$1,346,000 at December 31, 2007. The impairment charge is recorded as a reduction of noninterest income.

The following table presents information on the amortized cost, maturities, and taxable equivalent yields of securities at the end of the last three years.

Table 7 - Securities Portfolio

(in thousands, except yields)

| | 2007 | | December 31, 2006 | | 2005 | |
|-----------------------------|-------------------|--------------------------------|----------------------|--------------------------------|-------------------|--------------------------------|
| | Amortized Cost | Taxable Equivalent Yield | Amortized Cost | Taxable Equivalent Yield | Amortized Cost | Taxable Equivalent Yield |
| Federal Agencies: | | | | | | |
| Within 1 year | \$ 4,000 | 3.46% | \$ 36,969 | 3.92% | \$ 27,005 | 2.77% |
| 1 to 5 years | 45,170 | 4.79 | 45,432 | 4.62 | 44,353 | 3.49 |
| 5 to 10 years | 6,180 | 5.46 | 6,706 | 4.67 | 10,905 | 4.55 |
| Over 10 years | - | - | - | - | - | - |
| Total | 55,350 | 4.77 | 89,107 | 4.34 | 82,263 | 3.40 |
| Mortgage-backed: | | | | | | |
| Within 1 year | 108 | 3.43 | - | - | - | - |
| 1 to 5 years | 3,461 | 4.33 | 4,460 | 4.51 | 4,142 | 4.18 |
| 5 to 10 years | 14,411 | 4.85 | 8,345 | 4.83 | 10,227 | 4.78 |
| Over 10 years | 27,674 | 5.34 | 6,805 | 5.06 | 6,908 | 4.11 |
| Total | 45,654 | 5.10 | 19,610 | 4.84 | 21,277 | 4.44 |
| State and Municipal: | | | | | | |
| Within 1 year | 4,025 | 5.60 | 1,330 | 6.69 | 3,395 | 6.30 |
| 1 to 5 years | 24,443 | 4.97 | 23,036 | 5.15 | 23,321 | 5.65 |
| 5 to 10 years | 11,679 | 5.63 | 16,550 | 5.16 | 19,446 | 5.06 |
| Over 10 years | 7,878 | 5.73 | 5,179 | 6.03 | 3,040 | 6.15 |
| Total | 48,025 | 5.31 | 46,095 | 5.30 | 49,202 | 5.49 |
| Other Securities: | | | | | | |
| Within 1 year | - | - | 1,005 | 6.06 | 4,511 | 6.09 |

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| | | | | | | |
|-----------------|------------|-------|------------|-------|------------|-------|
| 1 to 5 years | 1,485 | 3.32 | 1,485 | 3.32 | 3,514 | 4.91 |
| 5 to 10 years | - | - | - | - | - | - |
| Over 10 years | 4,994 | 6.56 | 6,401 | 6.21 | 5,952 | 3.62 |
| Total | 6,479 | 5.82 | 8,891 | 5.71 | 13,977 | 4.74 |
| Total portfolio | \$ 155,508 | 5.08% | \$ 163,703 | 4.74% | \$ 166,719 | 4.26% |

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Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans increased \$36,283,000, or 7.1%, from 2006 to 2007. Average loans increased \$98,913,000, or 23.9% from 2005 to 2006. This increase was due largely to the acquisition of Community First, which occurred in April 2006.

Period-end loans increased \$9,163,000, or 1.7%, from December 31, 2006 to December 31, 2007. The increase was primarily due to growth in commercial real estate loans.

Loans held for sale are loans originated and in process of being sold to the secondary market. These loans are sold servicing released and totaled \$1,368,000 at December 31, 2007, and \$1,662,000 at December 31, 2006.

The following table provides loan balances, percentage of portfolio (excluding loans held for sale), and the percentage change since December 31, 2006 of loans outstanding by geographic region. The loans are allocated to the region in which they were originated. In some circumstances, loans may be originated in one region for borrowers located in other regions.

Table 8 - Loans by Geographic Region

| (dollars in thousands) | December 31, 2007 | | Percentage Change in Balance Since December 31, 2006 |
|------------------------------------|-------------------|-------------------------------|---|
| | Balance | Percentage of Portfolio | |
| Danville region | \$206,037 | 37.4% | (4.5)% |
| Lynchburg region | 151,018 | 27.4 | 3.8 |
| Southside region: | | | |
| Martinsville and Henry County | 108,065 | 19.6 | 9.8 |
| Halifax and Pittsylvania County | 63,204 | 11.4 | 3.1 |
| Greensboro area | 23,067 | 4.2 | 8.7 |
| Total loans | \$551,391 | 100.0% | |

The Company does not participate in highly leveraged lending transactions, as defined by bank regulations, and there are no loans of this nature recorded in the loan portfolio. The Company has no foreign loans in its portfolio. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2007 or 2006, loans to lessors of nonresidential buildings represented 11.0% of total loans at December 31, 2007; the lessees and lessors are engaged in a variety of industries.

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Table 9 illustrates loans by type.

Table 9 - Loans

| (in thousands) | December 31, | | | | |
|-----------------------------------|------------------|------------------|------------------|------------------|------------------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| Real estate: | | | | | |
| Construction and land development | \$ 69,803 | \$ 69,404 | \$ 50,092 | \$ 34,101 | \$ 12,790 |
| Commercial real estate | 198,332 | 186,639 | 142,968 | 147,653 | 136,395 |
| Residential real estate | 133,899 | 131,126 | 94,405 | 91,672 | 94,032 |
| Home equity | 48,313 | 52,531 | 42,178 | 42,620 | 42,197 |
| Total real estate | 450,347 | 439,700 | 329,643 | 316,046 | 285,414 |
| Commercial and industrial | 91,028 | 91,511 | 76,735 | 75,847 | 97,114 |
| Consumer | 10,016 | 11,017 | 10,709 | 15,376 | 23,717 |
| Total loans | \$551,391 | \$542,228 | \$417,087 | \$407,269 | \$406,245 |

The following table presents the maturity schedule of selected loan types.

Table 10 - Maturities of Selected Loan Types
December 31, 2007
(in thousands)

| | Commercial and Industrial (1) | Real Estate Construction | Total |
|----------------|--|-----------------------------|-------------------|
| 1 year or less | \$ 52,482 | \$ 53,599 | \$ 106,081 |
| 1 to 5 years | 31,803 | 15,357 | 47,160 |
| After 5 years | 6,743 | 847 | 7,590 |
| Total | \$ 91,028 | \$ 69,803 | \$ 160,831 |

Of the loans due after one year, \$39,507 have predetermined interest rates and \$15,242 have floating or adjustable interest rates.

(1) includes agricultural loans

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 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.

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.

Calculations of the allowance for loan losses are prepared quarterly by the Loan Review department. The calculations are reviewed for adequacy each quarter by the Company's Credit Committee, Audit and Compliance Committee, and Board of Directors. In determining the adequacy of the allowance for loan losses, factors which are considered include the Company's 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 and local economic conditions.

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

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 relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, management cannot provide assurance that, in any particular period, the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time, including economic conditions, industry trends, and ongoing internal and external examination processes. The allowance is 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 Southern 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 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 for loan losses was \$7,395,000 at December 31, 2007, compared with \$7,264,000 and \$6,109,000 at December 31, 2006 and 2005, respectively. The allowance for loan losses as a percentage of loans at each of these dates was 1.34%, 1.34%, and 1.46%, respectively. The increase in the allowance from December 31, 2005 to December 31, 2006 was largely due to loan growth associated with the Community First acquisition. The provision for loan losses was \$403,000 in 2007, \$58,000 in 2006, and \$465,000 in 2005.

Loans charged-off net of recoveries totaled \$272,000 in 2007, \$501,000 in 2006, and \$2,300,000 in 2005. One loan, secured by a hotel in a major North Carolina metropolitan area, accounted for \$2,100,000 of the net charge-offs in 2005. The loan was determined to be impaired and was placed on nonaccrual status in 2004. The loan was sold at a discount and the remaining balance charged-off in 2005. Table 14 presents the Company's loan loss and recovery experience for the past five years.

The allowance for loan losses is allocated to loan types 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. Table 12 summarizes the allocation of the allowance for loan losses for the past five years.

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The following table shows loans that were considered impaired as of year end.

Table 11 - Impaired Loans

| (in thousands) | December 31, | | | | |
|-----------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| Not on nonaccrual status | \$ 2,255 | \$ 262 | \$ 537 | \$ 1,007 | \$ 391 |
| On nonaccrual status | 1,310 | 1,114 | 2,995 | 5,303 | 2,548 |
| Total impaired loans | \$ 3,565 | \$ 1,376 | \$ 3,532 | \$ 6,310 | \$ 2,939 |

Table 12 - Allocation of Allowance for Loan Losses
(dollars in thousands)

| | 2007 | | 2006 | | December 31, 2005 | | 2004 | | 2003 | |
|--|-----------------|-------------|-----------------|-------------|-------------------|-------------|-----------------|-------------|-----------------|-------------|
| | \$ | % (1) | \$ | % (1) | \$ | % (1) | \$ | % (1) | \$ | % (1) |
| Commercial (including commercial real estate) | \$ 5,056 | 62% | \$ 4,467 | 61% | \$ 3,897 | 64% | \$ 5,927 | 61% | \$ 2,881 | 59% |
| Residential real estate | 1,852 | 36 | 2,119 | 37 | 1,462 | 33 | 1,231 | 35 | 848 | 35 |
| Consumer | 443 | 2 | 521 | 2 | 653 | 3 | 816 | 4 | 1,141 | 6 |
| Unallocated | 44 | - | 157 | - | 97 | - | 8 | - | 422 | - |
| Total | \$ 7,395 | 100% | \$ 7,264 | 100% | \$ 6,109 | 100% | \$ 7,982 | 100% | \$ 5,292 | 100% |

(1) Represents the percentage of loans in each category to total loans.

Table 13 - Asset Quality Ratios

| | As of or for the Years Ended December 31, | | | | |
|--|---|-------|-------|-------|-------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| Allowance to loans* | 1.34% | 1.34% | 1.46% | 1.96% | 1.30% |
| Net charge-offs to year-end allowance | 3.68 | 6.90 | 38.27 | 5.07 | 23.62 |
| Net charge-offs to average loans | 0.05 | 0.10 | 0.56 | 0.10 | 0.30 |

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| | | | | | |
|---------------------------------------|--------|-------|-------|--------|-------|
| Nonperforming assets to total assets* | 0.42 | 0.45 | 0.72 | 1.35 | 0.56 |
| Nonperforming loans to loans* | 0.48 | 0.63 | 1.02 | 1.99 | 0.82 |
| Provision to net charge-offs | 148.16 | 11.58 | 19.89 | 764.20 | 73.60 |
| Provision to average loans | 0.07 | 0.01 | 0.11 | 0.77 | 0.22 |
| Allowance to nonperforming loans* | 2.80 | 2.12 | 1.43 | 0.98 | 1.60 |

* - at year end

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Table 14 - Summary of Loan Loss Experience
(in thousands)

| | Year Ended December 31, | | | | |
|-----------------------------------|-------------------------|----------|----------|----------|----------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| Balance at beginning of period | \$ 7,264 | \$ 6,109 | \$ 7,982 | \$ 5,292 | \$ 5,622 |
| Allowance from acquisition | - | 1,598 | - | - | - |
| Charge-offs: | | | | | |
| Construction and land development | - | 1 | - | - | - |
| Commercial real estate | 54 | 136 | 2,249 | - | - |
| Residential real estate | 140 | 163 | 35 | 85 | 71 |
| Home equity | 19 | - | - | 44 | 9 |
| Total real estate | 213 | 300 | 2,284 | 129 | 80 |
| Commercial and industrial | 103 | 354 | 76 | 169 | 1,004 |
| Consumer | 199 | 259 | 217 | 357 | 373 |
| Total charge-offs | 515 | 913 | 2,577 | 655 | 1,457 |
| Recoveries: | | | | | |
| Construction and land development | - | 1 | - | - | - |
| Commercial real estate | 15 | 98 | 46 | 49 | - |
| Residential real estate | 3 | 11 | 3 | - | - |
| Home equity | 1 | 1 | - | - | - |
| Total real estate | 19 | 111 | 49 | 49 | - |
| Commercial and industrial | 50 | 108 | 11 | 45 | 105 |
| Consumer | 174 | 193 | 179 | 156 | 102 |
| Total recoveries | 243 | 412 | 239 | 250 | 207 |
| Net charge-offs | 272 | 501 | 2,338 | 405 | 1,250 |
| Provision for loan losses | 403 | 58 | 465 | 3,095 | 920 |
| Balance at end of period | \$ 7,395 | \$ 7,264 | \$ 6,109 | \$ 7,982 | \$ 5,292 |

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Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented 0.48% of total loans at December 31, 2007, down from 0.63% at December 31, 2006. There were no troubled debt restructurings at the end of any of the years presented in the table.

Table 15 - Nonperforming Assets

| (in thousands) | December 31, | | | | |
|--|--------------|----------|----------|----------|----------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| Nonaccrual loans: | | | | | |
| Real estate | \$ 2,488 | \$ 3,195 | \$ 4,098 | \$ 7,005 | \$ 1,870 |
| Commercial | 107 | 151 | 12 | 853 | 1,236 |
| Agricultural | - | - | - | 12 | 8 |
| Consumer | 44 | 79 | 107 | 243 | 148 |
| Total nonaccrual loans | 2,639 | 3,425 | 4,217 | 8,113 | 3,262 |
| Restructured loans | - | - | - | - | - |
| Loans past due 90 days and accruing interest: | | | | | |
| Real estate | - | - | 46 | - | - |
| Commercial | - | - | 10 | - | - |
| Agricultural | - | - | - | - | - |
| Consumer | - | - | - | - | 53 |
| Total past due loans | - | - | 56 | - | 53 |
| Total nonperforming loans | 2,639 | 3,425 | 4,273 | 8,113 | 3,315 |
| Foreclosed real estate | 632 | 99 | 188 | 221 | 303 |
| Total nonperforming assets | \$ 3,271 | \$ 3,524 | \$ 4,461 | \$ 8,334 | \$ 3,618 |

Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Average deposits increased \$1,350,000, or 0.2%, in 2007, after increasing \$106,278,000, or 22.0% in 2006. The increase in 2006 was due primarily to the acquisition of Community First. Period-end deposits declined \$27,307,000, or 4.5%, from December 31, 2006 to December 31, 2007. The decline in period-end deposits is attributed primarily to the maturity of high-rate certificates of deposits acquired from Community First and intense competition for deposits.

During 2007, approximately \$20,285,000 in high-rate certificates of deposit acquired from Community First matured, contributing to a \$9,423,000 decrease in time deposits. Savings deposits continued to decline in 2007, as customers sought higher-yielding accounts. Savings deposits decreased \$7,117,000 from December 31, 2006 to December 31, 2007. Demand deposits declined \$10,073,000, or 4.7%. Money market deposits declined moderately, from \$50,948,000 at December 31, 2006 to \$50,254,000 at December 31, 2007.

Table 16 - Deposits
(in thousands, except rates)

| | 2007 | | December 31, 2006 | | 2005 | |
|------------------------|--------------------|-------|----------------------|-----------------|--------------------|-----------------|
| | Average Balance | Rate | Average Balance | Average Rate | Average Balance | Average Rate |
| Demand deposits | | | | | | |
| - | | | | | | |
| noninterest bearing | \$102,003 | -% | \$102,117 | -% | \$ 84,670 | -% |
| Demand deposit - | | | | | | |
| interest bearing | 107,834 | 1.44 | 105,320 | 1.44 | 82,121 | 0.66 |
| Money market | 52,843 | 2.70 | 48,124 | 2.45 | 44,685 | 1.60 |
| Savings | 66,246 | 1.28 | 77,445 | 1.24 | 81,641 | 0.77 |
| Time | 261,286 | 4.48 | 255,856 | 3.79 | 189,467 | 2.65 |
| | \$590,212 | 2.63% | \$588,862 | 2.27% | \$482,584 | 1.43% |

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Table 17 - Certificates of Deposit of \$100,000 or More
(in thousands)

Certificates of deposit at December 31, 2007 in amounts of \$100,000 or more were classified by maturity as follows:

| | | |
|--------------------------|----|---------|
| 3 months or less | \$ | 20,144 |
| Over 3 through 6 months | | 29,212 |
| Over 6 through 12 months | | 25,638 |
| Over 12 months | | 26,218 |
| | \$ | 101,212 |

Borrowed Funds

In addition to internal deposit generation, the Company also relies on borrowed funds as a supplemental source of funding. Borrowed funds consist of customer repurchase agreements, overnight borrowings from the Federal Home Loan Bank of Atlanta (“FHLB”) and longer-term FHLB advances, and trust preferred capital notes. Repurchase agreements are borrowings collateralized by securities of the U.S. Government or its agencies and mature daily. The Company considers these accounts to be stable sources of funds, as they represent customer sweep accounts. The securities underlying these agreements remain under the Company’s control.

The following table presents information pertaining to the Company’s short-term borrowed funds.

Table 18 - Short-Term Borrowed Funds
(dollars in thousands)

| | December 31, | |
|-------------------------------|--------------|-----------|
| | 2007 | 2006 |
| Repurchase agreements | \$ 47,891 | \$ 33,368 |
| Short term FHLB borrowings | 7,200 | - |
| Total | \$ 55,091 | \$ 33,368 |
| Weighted interest rate | 3.78% | 3.69% |
| Average for the year ended: | | |
| Outstanding | \$ 48,435 | \$ 42,210 |
| Interest rate | 3.84% | 3.44% |
| Maximum month-end outstanding | \$ 55,091 | \$ 54,527 |

Shareholders’ Equity

The Company’s goal with capital management is to generate attractive returns on equity and pay high dividends while maintaining capital sufficient to be classified as “well capitalized” under regulatory capital ratios and to support growth.

Shareholders’ equity was \$101,511,000 at December 31, 2007 and \$94,992,000 at December 31, 2006. The increase was largely the result of net income and comprehensive income. These increases were partially offset by dividends and the effect of share repurchases.

Shareholders' equity increased from \$73,419,000 at December 31, 2005 to \$94,992,000 at December 31, 2006. During 2006, shareholders' equity was increased by the acquisition of Community First, net income, and proceeds from the exercise of stock options, and was decreased by dividends, stock repurchases, and a decrease in accumulated other comprehensive income. The decrease in accumulated other comprehensive income was largely due to the adoption of SFAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, which resulted in a \$1,465,000, net of tax, reduction.

The Company declared and paid quarterly dividends totaling \$0.91, \$0.87, and \$0.83 per share of common stock in 2007, 2006, and 2005 respectively. Cash dividends in 2007 totaled \$5,587,000 and represented a 48.8% payout of 2007 net income, compared to 45.6% in 2006 and 45.3% in 2005.

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One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Shareholders' equity was 13.14% of assets at December 31, 2007 and 12.21% at December 31, 2006. In addition to this measurement, 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 shareholder's equity and trust preferred capital notes, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total 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 December 31, 2007, the Company's Tier I and total capital ratios were 17.03% and 18.28%, respectively. At December 31, 2006, these ratios were 16.18% and 17.45%, respectively. The ratios for both years exceeded the regulatory requirements. The Company's leverage ratios were 12.98% and 12.15% at December 31, 2007 and 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%, leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of December 31, 2007 and 2006, that the Company met the requirements to be considered "well capitalized."

CONTRACTUAL OBLIGATIONS

The following items are contractual obligations of the Company as of December 31, 2007 (in thousands):

| | Payments Due By Period | | | | |
|----------------------------------|------------------------|-----------------|-----------|-----------|----------------------|
| | Total | Under 1 Year | 1-3 Years | 3-5 Years | More than 5 years |
| Time deposits | \$ 264,585 | \$ 203,919 | \$ 39,313 | \$ 21,198 | \$ 155 |
| FHLB borrowings | 16,137 | 10,200 | 5,000 | - | 937 |
| Repurchase agreements | 47,891 | 47,891 | - | - | - |
| Operating leases | 923 | 311 | 485 | 117 | 10 |
| Trust preferred capital notes | 26,798 | 1,373 | 2,746 | 22,679 | - |

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 the "Borrowed

Funds” section for discussion of AMNB Statutory Trust I. Off-balance sheet transactions were as follows (in thousands):

| Off-Balance Sheet Transactions | December 31, | |
|--|--------------|------------|
| | 2007 | 2006 |
| Commitments to extend credit | \$ 144,301 | \$ 155,038 |
| Standby letters of credit | 6,222 | 3,125 |
| Mortgage loan rate-lock commitments | 2,215 | 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.

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ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Table 19 - Quarterly Financial Results
(in thousands, except per share amounts)

| | 2007 | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|--|------|-------------------|------------------|-------------------|------------------|
| Interest income | | \$12,300 | \$12,293 | \$12,106 | \$11,898 |
| Interest expense | | 4,842 | 4,947 | 4,823 | 4,758 |
| Net interest income | | 7,458 | 7,346 | 7,283 | 7,140 |
| Provision for loan losses | | 100 | - | - | 303 |
| Net interest income after provision for loan losses | | 7,358 | 7,346 | 7,283 | 6,837 |
| Noninterest income | | 1,903 | 2,276 | 2,431 | 2,212 |
| Noninterest expense | | 5,329 | 5,379 | 5,448 | 5,170 |
| Income before income taxes | | 3,932 | 4,243 | 4,266 | 3,879 |
| Income taxes | | 1,157 | 1,309 | 1,235 | 1,175 |
| Net income | | \$ 2,775 | \$ 2,934 | \$ 3,031 | \$ 2,704 |
| Per common share: | | | | | |
| Net income - basic | | \$ 0.45 | \$ 0.48 | \$ 0.49 | \$ 0.44 |
| Net income - diluted | | 0.45 | 0.48 | 0.49 | 0.44 |
| Cash dividends | | 0.23 | 0.23 | 0.23 | 0.22 |
| | 2006 | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Interest income | | \$11,925 | \$12,151 | \$12,146 | \$ 8,848 |
| Interest expense | | 4,752 | 4,645 | 4,435 | 2,829 |
| Net interest income | | 7,173 | 7,506 | 7,711 | 6,019 |
| Provision for loan losses | | (547) | 125 | 354 | 126 |
| Net interest income after provision for loan losses | | 7,720 | 7,381 | 7,357 | 5,893 |
| Noninterest income | | 2,152 | 2,138 | 2,267 | 1,901 |
| Noninterest expense | | 5,408 | 5,117 | 5,356 | 4,383 |
| Income before income taxes | | 4,464 | 4,402 | 4,268 | 3,411 |
| Income taxes | | 1,547 | 1,301 | 1,266 | 1,005 |

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| | | | | |
|----------------------|----------|----------|----------|----------|
| Net income | \$ 2,917 | \$ 3,101 | \$ 3,002 | \$ 2,406 |
| Per common share: | | | | |
| Net income - basic | \$ 0.47 | \$ 0.50 | \$ 0.49 | \$ 0.44 |
| Net income - diluted | 0.47 | 0.50 | 0.48 | 0.44 |
| Cash dividends | 0.22 | 0.22 | 0.22 | 0.21 |

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ITEM 9A – 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 December 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 year ended December 31, 2007 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Management regularly monitors its internal control over financial reporting, and actions are taken to correct deficiencies as they are identified.

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting. This assessment was based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation under the framework in Internal Control – Integrated Framework, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2007, as such term is defined in Exchange Act Rules 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, because of changes in conditions, internal control effectiveness may vary over time.

The Company's independent registered public accounting firm, Yount, Hyde and Barbour, P.C., has audited the Company's internal control over financial reporting as of December 31, 2007, as stated in their report included herein. Yount, Hyde and Barbour, P.C. also audited the Company's consolidated financial statements as of and for the year ended December 31, 2007.

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

/s/ Neal A. Petrovich
Neal A. Petrovich
Senior Vice President and

Chief Financial Officer

March 10, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
American National Bankshares Inc.
Danville, Virginia

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have audited the accompanying consolidated balance sheets of American National Bankshares Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2007. We also have audited American National Bankshares Inc. and subsidiaries' internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). American National Bankshares Inc. and subsidiaries' management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American National Bankshares Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, American National Bankshares Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Winchester, Virginia
March 10, 2008

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American National Bankshares Inc. and Subsidiaries
Consolidated Balance Sheets
December 31, 2007 and 2006
(Dollars in thousands, except share data)

| ASSETS | 2007 | 2006 |
|--|------------|------------|
| Cash and due from banks | \$ 18,155 | \$ 24,375 |
| Interest-bearing deposits in other banks | 149 | 1,749 |
| Securities available for sale, at fair value | 145,159 | 148,748 |
| Securities held to maturity (fair value of \$12,250 in 2007 and \$14,131 in 2006) | 11,990 | 13,873 |
| Total securities | 157,149 | 162,621 |
| Loans held for sale | 1,368 | 1,662 |
| Loans, net of unearned income | 551,391 | 542,228 |
| Less allowance for loan losses | (7,395) | (7,264) |
| Net loans | 543,996 | 534,964 |
| Premises and equipment, net | 13,348 | 12,438 |
| Goodwill | 22,468 | 22,468 |
| Core deposit intangibles, net | 2,452 | 2,829 |
| Accrued interest receivable and other assets | 13,203 | 14,614 |
| Total assets | \$ 772,288 | \$ 777,720 |
| LIABILITIES and SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits -- noninterest bearing | \$ 99,231 | \$ 106,885 |
| Demand deposits -- interest bearing | 104,751 | 107,170 |
| Money market deposits | 50,254 | 50,948 |
| Savings deposits | 62,400 | 69,517 |
| Time deposits | 264,585 | 274,008 |
| Total deposits | 581,221 | 608,528 |
| Repurchase agreements | 47,891 | 33,368 |
| FHLB borrowings | 16,137 | 15,087 |
| Trust preferred capital notes | 20,619 | 20,619 |
| Accrued interest payable and other liabilities | 4,909 | 5,126 |
| Total liabilities | 670,777 | 682,728 |
| Shareholders' equity: | | |
| Preferred stock, \$5 par, 200,000 shares authorized, none outstanding | - | - |
| Common stock, \$1 par, 10,000,000 shares authorized, 6,118,717 shares outstanding at December 31, 2007 and 6,161,865 shares outstanding at December 31, 2006 | 6,119 | 6,162 |
| Capital in excess of par value | 26,425 | 26,414 |
| Retained earnings | 69,409 | 64,584 |
| Accumulated other comprehensive income (loss), net | (442) | (2,168) |

| | | |
|--|------------|------------|
| Total shareholders' equity | 101,511 | 94,992 |
| Total liabilities and shareholders' equity | \$ 772,288 | \$ 777,720 |

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

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American National Bankshares Inc. and Subsidiaries
 Consolidated Statements of Income
 For the Years Ended December 31, 2007, 2006 and 2005
 (Dollars in thousands, except share and per share data)

| | 2007 | 2006 | 2005 |
|---|-----------|-----------|-----------|
| Interest and Dividend Income: | | | |
| Interest and fees on loans | \$ 41,499 | \$ 37,361 | \$ 25,825 |
| Interest and dividends on securities: | | | |
| Taxable | 4,409 | 5,034 | 4,090 |
| Tax-exempt | 1,690 | 1,743 | 2,010 |
| Dividends | 320 | 312 | 215 |
| Other interest income | 679 | 620 | 339 |
| Total interest and dividend income | 48,597 | 45,070 | 32,479 |
| Interest Expense: | | | |
| Interest on deposits | 15,535 | 13,349 | 6,902 |
| Interest on repurchase agreements | 1,841 | 1,384 | 901 |
| Interest on FHLB borrowings | 621 | 921 | 937 |
| Interest on trust preferred capital notes | 1,373 | 1,007 | - |
| Total interest expense | 19,370 | 16,661 | 8,740 |
| Net Interest Income | 29,227 | 28,409 | 23,739 |
| Provision for Loan Losses | 403 | 58 | 465 |
| Net Interest Income after Provision for Loan Losses | 28,824 | 28,351 | 23,274 |
| Noninterest Income: | | | |
| Trust fees | 3,578 | 3,374 | 3,012 |
| Service charges on deposit accounts | 2,531 | 2,654 | 2,446 |
| Other fees and commissions | 786 | 744 | 693 |
| Mortgage banking income | 954 | 709 | 665 |
| Brokerage fees | 550 | 419 | 385 |
| Securities gains, net | 135 | 62 | 53 |
| Impairment of securities | (362) | - | - |
| Other | 650 | 496 | 642 |
| Total noninterest income | 8,822 | 8,458 | 7,896 |
| Noninterest Expense: | | | |
| Salaries | 9,688 | 9,520 | 8,453 |
| Employee benefits | 2,749 | 2,506 | 1,975 |
| Occupancy and equipment | 3,527 | 2,977 | 2,476 |
| Bank franchise tax | 663 | 651 | 543 |
| Core deposit intangible amortization | 377 | 414 | 353 |
| Other | 4,322 | 4,196 | 3,279 |
| Total noninterest expense | 21,326 | 20,264 | 17,079 |
| Income Before Income Taxes | 16,320 | 16,545 | 14,091 |
| Income Taxes | 4,876 | 5,119 | 4,097 |
| Net Income | \$ 11,444 | \$ 11,426 | \$ 9,994 |
| Net Income Per Common Share: | | | |
| Basic | \$ 1.86 | \$ 1.91 | \$ 1.83 |
| Diluted | \$ 1.86 | \$ 1.90 | \$ 1.81 |
| Average Common Shares Outstanding: | | | |

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| | | | |
|---------|-----------|-----------|-----------|
| Basic | 6,139,095 | 5,986,262 | 5,465,090 |
| Diluted | 6,161,825 | 6,020,071 | 5,506,998 |

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

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American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2007, 2006, and 2005
Dollars in thousands

| | Common Stock | | Capital in | Retained | Accumulated | Total |
|---|--------------|----------|------------------------|-----------|---|-------------------------|
| | Shares | Amount | Excess of Par Value | Earnings | Other Comprehensive Income (Loss) | Shareholders' Equity |
| Balance, December 31, 2004 | 5,521,164 | \$ 5,521 | \$ 9,474 | \$ 55,780 | \$ 225 | \$ 71,000 |
| Net income | - | - | - | 9,994 | - | 9,994 |
| Change in unrealized losses on securities available for sale, net of tax of \$(468) | - | - | - | - | (910) | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$ (18) | - | - | - | - | (35) | |
| Other comprehensive loss | | | | | (945) | (945) |
| Comprehensive income | | | | | | 9,049 |
| Stock repurchased and retired | (98,840) | (98) | (170) | (2,136) | - | (2,404) |
| Stock options exercised | 19,434 | 19 | 284 | - | - | 303 |
| Cash dividends declared | - | - | - | (4,529) | - | (4,529) |
| Balance, December 31, 2005 | 5,441,758 | 5,442 | 9,588 | 59,109 | (720) | 73,419 |
| Net income | - | - | - | 11,426 | - | 11,426 |
| Change in unrealized losses on securities available for sale, net of tax of \$32 | - | - | - | - | 58 | |
| Less: Reclassification adjustment for gains on securities available for sale, net of | | | | | | |

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| | | | | | | |
|--|-----------|-------|--------|---------|---------|---------|
| tax of \$ (21) | - | - | - | - | (41) | |
| Other comprehensive income | | | | | 17 | 17 |
| Comprehensive income | | | | | | 11,443 |
| Adjustment to initially apply FASB statement | | | | | | |
| No. 158, net of tax of (\$789) | - | - | - | - | (1,465) | (1,465) |
| Issuance of common stock in exchange for net assets acquisition | 746,944 | 747 | 16,799 | - | - | 17,546 |
| Stock repurchased and retired | (39,100) | (39) | (132) | (741) | - | (912) |
| Stock options exercised | 12,263 | 12 | 159 | - | - | 171 |
| Cash dividends declared | - | - | - | (5,210) | - | (5,210) |
| Balance, December 31, 2006 | 6,161,865 | 6,162 | 26,414 | 64,584 | (2,168) | 94,992 |
| Net income | - | - | - | 11,444 | - | 11,444 |
| Change in unrealized gains on securities available for sale, net of tax of \$874 | - | - | - | - | 1,622 | |
| Add: Reclassification adjustment for losses on impairment of securities, net of tax of \$127 | | | | | 235 | |
| Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$(47) | - | - | - | - | (88) | |
| Change in unfunded person liability, net of tax of (\$23) | | | | | (43) | |
| Other comprehensive income | | | | | 1,726 | 1,726 |
| Comprehensive income | | | | | | 13,170 |
| Stock repurchased and retired | (61,900) | (62) | (265) | (1,032) | - | (1,359) |
| Stock options exercised | 18,752 | 19 | 276 | - | - | 295 |

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| | | | | | | |
|-------------------------|---|---|---|---------|---|---------|
| Cash dividends declared | - | - | - | (5,587) | - | (5,587) |
|-------------------------|---|---|---|---------|---|---------|

| | | | | | | | | | | | |
|----------------------------|-----------|----|-------|----|--------|----|--------|----|-------|----|---------|
| Balance, December 31, 2007 | 6,118,717 | \$ | 6,119 | \$ | 26,425 | \$ | 69,409 | \$ | (442) | \$ | 101,511 |
|----------------------------|-----------|----|-------|----|--------|----|--------|----|-------|----|---------|

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

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American National Bankshares Inc. and Subsidiaries
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2007, 2006, and 2005
(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|---|-----------|-----------|----------|
| Cash Flows from Operating Activities: | | | |
| Net income | \$ 11,444 | \$ 11,426 | \$ 9,994 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Provision for loan losses | 403 | 58 | 465 |
| Depreciation | 1,178 | 993 | 866 |
| Core deposit intangible amortization | 377 | 414 | 353 |
| Net amortization (accretion) of bond premiums and discounts | (188) | (51) | 227 |
| Net gain on sale or call of securities | (135) | (62) | (53) |
| Impairment of securities | 362 | - | - |
| Gain on loans held for sale | (733) | (434) | (431) |
| Proceeds from sales of loans held for sale | 31,451 | 15,673 | 18,255 |
| Originations of loans held for sale | (30,424) | (16,187) | (17,567) |
| Net gain on foreclosed real estate | (6) | (7) | (4) |
| Change in valuation allowance on foreclosed real estate | - | 10 | 35 |
| Gain on sale of premises and equipment | (8) | - | (6) |
| Deferred income tax (benefit) expense | (67) | 732 | 569 |
| Change in interest receivable | 316 | (54) | (16) |
| Change in other assets | 699 | (1,369) | (953) |
| Change in interest payable | 39 | 429 | 261 |
| Change in other liabilities | (257) | (703) | 1,220 |
| Net cash provided by operating activities | 14,451 | 10,868 | 13,215 |
| Cash Flows from Investing Activities: | | | |
| Proceeds from sales of securities available for sale | 1,070 | 503 | 420 |
| Proceeds from maturities and calls of securities available for sale | 54,965 | 57,920 | 106,908 |
| Proceeds from maturities and calls of securities held to maturity | 1,884 | 4,491 | 3,870 |
| Purchases of securities available for sale | (49,763) | (51,716) | (90,268) |
| Purchases of securities held to maturity | - | - | - |
| Change in loans | (9,933) | 10,278 | (12,218) |
| Proceeds from sale of bank property and equipment | 25 | 324 | 9 |
| Purchases of bank property and equipment | (2,105) | (1,045) | (1,121) |
| Proceeds from sales of foreclosed real estate | 30 | 421 | 65 |
| Increases in foreclosed real estate | (59) | (230) | (1) |

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| | | | |
|--|-----------|-----------|-----------|
| Cash paid in bank acquisition | - | (17,087) | - |
| Cash acquired in bank acquisition | - | 2,956 | - |
| Net cash (used in) provided by investing activities | (3,886) | 6,815 | 7,664 |
| Cash Flows from Financing Activities: | | | |
| Net change in demand, money market, and savings deposits | (17,884) | (9,915) | 8,038 |
| Net change in time deposits | (9,423) | (15,180) | (1,659) |
| Net change in repurchase agreements | 14,523 | (3,835) | (1,742) |
| Net change in FHLB borrowings | 1,050 | (2,151) | (4,100) |
| Net change in other borrowings | - | 18,119 | - |
| Cash dividends paid | (5,587) | (5,210) | (4,529) |
| Repurchase of stock | (1,359) | (912) | (2,404) |
| Proceeds from exercise of stock options | 295 | 171 | 303 |
| Net cash used in financing activities | (18,385) | (18,913) | (6,093) |
| Net (Decrease) Increase in Cash and Cash Equivalents | (7,820) | (1,230) | 14,786 |
| Cash and Cash Equivalents at Beginning of Period | 26,124 | 27,354 | 12,568 |
| Cash and Cash Equivalents at End of Period | \$ 18,304 | \$ 26,124 | \$ 27,354 |

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

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American National Bankshares Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2007, 2006, and 2005

Note 1 – Summary of Significant Accounting Policies

Nature of Operations and Consolidation

The consolidated financial statements include the accounts of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the “Company”). American National Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “Trust”) and a wholly owned subsidiary of the Company was formed for the purpose of issuing preferred securities (the “Trust Preferred Securities”) in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation which occurred in April 2006. Refer to Note 10 for further details concerning this variable interest entity.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the Trust, as detailed in Note 10.

Cash and Cash Equivalents

Cash includes cash on hand and cash with correspondent banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less and are subject to an insignificant risk of change in value. Cash and cash equivalents are carried at cost.

Securities

The Company classifies securities as either held to maturity or available for sale.

Debt securities that management has both the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost.

Securities which may be used to meet liquidity needs arising from deposit and loan fluctuations or changes in market conditions are classified as available for sale. Securities available for sale are reported at estimated fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of tax. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized impairment losses. In estimating other than temporary impairment losses, management considers (1) the length of time and extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for anticipated recovery in fair value. Gains or losses realized from the sale of securities available for sale are recorded on the trade date and are determined using the specific identification method.

The Company does not permit the purchase or sale of trading account securities.

Due to the nature and restrictions placed on the Company's investment in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank, these securities have been classified as restricted equity securities and carried at cost.

Loans Held for Sale

Secondary market mortgage loans are designated as held for sale at the time of their origination. These loans are pre-sold with servicing released and the Company does not retain any interest after the loans are sold. These loans consist primarily of fixed-rate, single-family residential mortgage loans which meet the underwriting characteristics of certain government-sponsored enterprises (conforming loans). In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be committed, thus limiting interest rate risk. Loans held for sale are carried at the lower of cost or estimated fair value in the aggregate. Gains on sales of loans are recognized at the loan closing date and are included in noninterest income for the period.

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Derivative Loan Commitments

The Company enters into mortgage loan commitments whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheets with net changes in their fair values recorded in other expenses. Derivative loan commitments resulted in expense of \$21,000 for 2007 and \$10,000 in income for 2006. There was no expense or income recognized in 2005.

The period of time between issuance of a loan commitment and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery contracts, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed the interest rate risk on the loan. As a result, the Company is not generally exposed to significant losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the estimated value of the underlying assets while taking into consideration the probability that the loan will be funded.

Loans

The Company grants mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is secured by real estate. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company's market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balance adjusted for the allowance for loan losses, and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off when the loan is 120 days past due, unless secured and in process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Substandard risk graded commercial loans equal to or greater than \$100,000 on an unsecured basis, and equal to or greater than \$250,000 on a secured basis are reviewed for impairment. 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. Factors considered by management in determining impairment and establishing a specific allowance include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience

insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Generally, large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The Company's policy for recognizing interest income on impaired loans is consistent with its nonaccrual policy.

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Accounting for Certain Loans or Debt Securities Acquired in a Transfer

In January 2005, American Institute of Certified Public Accountants Statement of Position (“SOP”) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, was adopted for loan acquisitions. SOP 03-3 requires acquired loans to be recorded at fair value and prohibits carrying over valuation allowances in the initial accounting for acquired impaired loans. Loans carried at fair value, mortgage loans held for sale, and loans to borrowers in good standing under revolving credit agreements are excluded from the scope of SOP 03-3. SOP 03-3 limits the yield that may be accreted to the excess of the undiscounted expected cash flows over the investor’s initial investment in the loan. The excess of the contractual cash flows over expected cash flows may not be recognized as an adjustment of yield. Subsequent increases in cash flows expected to be collected are recognized prospectively through an adjustment of the loan’s yield over its remaining life. Decreases in expected cash flows are recognized as impairments. Refer to Note 5 for disclosures required under SOP 03-3.

Allowance for Loan Losses

The allowance for loan losses is management’s estimate of probable credit losses that are inherent in the loan portfolio at the balance sheet date. Increases to the allowance are made by charges to the provision for loan losses, which is reflected in the Consolidated Statements of Income. Loan balances deemed to be uncollectible are charged-off against the allowance. Recoveries of previously charged-off amounts are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management’s periodic review of the loan portfolio in light of historical charge-off experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower’s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. The 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 when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses along with various economic factors and, as a result, could differ from the loss incurred in the future. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. The unallocated allowance captures losses whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Actual losses could be greater or less than the estimates.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to thirty-nine years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful lives of the improvements, whichever is less. Software is generally amortized over three years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

Goodwill and Intangible Assets

The Company adopted Statement of Financial Accounting Standards (“SFAS”) 142, Goodwill and Other Intangible Assets, in January 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 cost of purchased deposit relationships and other intangible assets, based on independent valuation, are being amortized over their estimated lives ranging from 8.25 years to 10 years.

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Trust Assets

Securities and other property held by the trust and investment services segment in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Foreclosed Real Estate

Foreclosed real estate is included in other assets and represents real estate that has been acquired through loan foreclosures or deeds received in lieu of loan payments. Generally, such properties are appraised at the time acquired, and are recorded at the lower of cost or fair value less estimated selling costs. When appropriate, adjustments to cost are charged or credited to the allowance for foreclosed properties.

Income Taxes

The Company uses the balance sheet method to account for deferred income tax assets and liabilities. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Stock-Based Compensation

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

Prior to 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. Refer to Note 11 for disclosures required under SFAS 123R.

Earnings Per Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the impact of additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company consist solely of outstanding stock options, and are determined using the treasury method.

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Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in the funded status of a defined benefit postretirement plan, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred, and were \$300,000, \$267,000, and \$174,000 in 2007, 2006, and 2005, respectively.

Use of Estimates in the Preparation of Financial Statements

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate.

Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year.

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS 157, “Fair Value Measurements.” SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. As of December 1, 2007, the FASB has proposed a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The Company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R).” SFAS 158 requires that employers measure plan assets and obligations as of the balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. The other provisions of SFAS 158 were implemented by the Company as of December 31, 2006. The Company does not expect the implementation of the measurement date provisions of SFAS 158 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.” SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement 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, with early adoption available in certain circumstances. The Company does not expect the implementation of SFAS 159 to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS 141(R), "Business Combinations." The standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements.

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In December 2007, the FASB issued SFAS 160, “Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51.” The standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity’s first fiscal year that begins after December 15, 2008, early adoption is prohibited. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

In September 2006, the Emerging Issues Task Force (“EITF”) issued EITF 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.” This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exists) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007, with early application permitted. The Company does not expect the implementation of EITF 06-4 to have a material impact on its consolidated financial statements.

In November 2006, the EITF issued EITF 06-10, “Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements.” In this issue, a consensus was reached that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either SFAS 106 or APB Opinion No. 12, as appropriate, if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death benefit based on the substantive agreement with the employee. A consensus also was reached that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. The consensus is effective for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years, with early application permitted. The Company does not expect the implementation of EITF 06-10 to have a material impact on its consolidated financial statements.

In February 2007, the FASB issued FASB Staff Position (“FSP”) No. FAS 158-1, “Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88 and No. 106 and to the Related Staff Implementation Guides.” This FSP provides conforming amendments to the illustrations in SFAS 87, 88, and 106 and to related staff implementation guides as a result of the issuance of SFAS 158. The conforming amendments made by this FSP are effective as of the effective dates of SFAS 158. The unaffected guidance that this FSP codifies into SFAS 87, 88, and 106 does not contain new requirements and therefore does not require a separate effective date or transition method. The Company does not expect the implementation of FSP No. FAS 158-1 to have a material impact on its consolidated financial statements.

In November 2007, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin (“SAB”) No. 109, “Written Loan Commitments Recorded at Fair Value Through Earnings.” SAB 109 expresses the current view of the staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SEC registrants are expected to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company does not expect the implementation of SAB 109 to have a material impact on its consolidated financial statements.

In December 2007, the SEC issued SAB 110, “Use of a Simplified Method in Developing Expected Term of Share Options.” SAB 110 expresses the current view of the staff that it will accept a company’s election to use the simplified method discussed in SAB 107 for estimating the expected term of “plain vanilla” share options regardless of whether the company has sufficient information to make more refined estimates. The staff noted that it understands that detailed information about employee exercise patterns may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company does not expect the implementation of SAB 110 to have a material impact on its consolidated

financial statements.

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Note 2 – Restrictions on Cash and Amounts Due From Banks

The Company is a member of the Federal Reserve System and is required to maintain certain levels of its cash and cash equivalents as reserves based on regulatory requirements. This reserve requirement was approximately \$7,368,000 at December 31, 2007 and \$6,020,000 at December 31, 2006.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2007 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$149,000.

Note 3 - Securities

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

| (in thousands) | December 31, 2007 | | | |
|-------------------------------------|-------------------|------------------|-------------------|----------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Securities available for sale: | | | | |
| Debt securities: | | | | |
| Federal agencies | \$ 55,350 | \$ 1,059 | \$ 33 | \$ 56,376 |
| Mortgage-backed | 45,346 | 565 | 97 | 45,814 |
| State and municipal | 36,343 | 258 | 113 | 36,488 |
| Corporate | 1,485 | - | 40 | 1,445 |
| Equity securities: | | | | |
| FHLB stock - restricted | 2,125 | - | - | 2,125 |
| Federal Reserve stock - restricted | 1,429 | - | - | 1,429 |
| FNMA and FHLMC preferred stock | 1,346 | 42 | - | 1,388 |
| Other | 94 | - | - | 94 |
| Total securities available for sale | 143,518 | 1,924 | 283 | 145,159 |
| Securities held to maturity: | | | | |
| Mortgage-backed | 308 | 11 | - | 319 |
| State and municipal | 11,682 | 256 | 7 | 11,931 |
| Total securities held to maturity | 11,990 | 267 | 7 | 12,250 |
| Total securities | \$ 155,508 | \$ 2,191 | \$ 290 | \$ 157,409 |

| (in thousands) | December 31, 2006 | | | |
|--------------------------------|-------------------|------------------|-------------------|----------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Securities available for sale: | | | | |
| Debt securities: | | | | |
| Federal agencies | \$ 88,106 | \$ 40 | \$ 819 | \$ 87,327 |
| Mortgage-backed | 19,225 | 104 | 353 | 18,976 |

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| | | | | |
|-------------------------------------|------------|--------|----------|------------|
| 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 amortized cost and estimated fair value of investments in securities at December 31, 2007, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities have both known principal repayment terms as well as unknown principal repayments due to potential borrower pre-payments, it is difficult to accurately predict the final maturity of these investments. Mortgage-backed securities are shown separately.

| (in thousands) | Available for Sale | | Held to Maturity | |
|--|--------------------|----------------------|------------------|----------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due in one year or less | \$ 5,070 | \$ 5,051 | \$ 2,955 | \$ 2,969 |
| Due after one year through five years | 67,483 | 68,536 | 4,154 | 4,197 |
| Due after five years through ten years | 13,782 | 13,852 | 4,473 | 4,661 |
| Due after ten years | 6,843 | 6,870 | 100 | 104 |
| Equity securities | 4,994 | 5,036 | - | - |
| Mortgage-backed securities | 45,346 | 45,814 | 308 | 319 |
| | \$ 143,518 | \$ 145,159 | \$ 11,990 | \$ 12,250 |

Gross realized gains and losses from the call of all securities or the sale of securities available for sale were as follows (in thousands):

| | For the Years Ended December 31, | | |
|-----------------|----------------------------------|-------|-------|
| | 2007 | 2006 | 2005 |
| Realized gains | \$ 135 | \$ 62 | \$ 54 |
| Realized losses | - | - | 1 |

Securities with a carrying value of approximately \$85,313,000 and \$83,500,000, at December 31, 2007 and 2006, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law.

Corporate bonds consist of investment grade debt securities, primarily issued by financial services companies.

The table below 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 December 31, 2007. 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.

| (in thousands) | Total | | Less than 12 Months | | 12 Months or More | |
|----------------|----------------|-----------------|---------------------|-----------------|-------------------|-----------------|
| | Estimated Fair | Unrealized Loss | Estimated Fair | Unrealized Loss | Estimated Fair | Unrealized Loss |

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| | Value | | Value | | Value | |
|---------------------|-----------|--------|----------|-------|-----------|--------|
| Federal agencies | \$ 7,459 | \$ 33 | \$ - | \$ - | \$ 7,459 | \$ 33 |
| Mortgage-backed | 10,194 | 97 | 3,508 | 35 | 6,686 | 62 |
| State and municipal | 17,858 | 120 | 2,087 | 12 | 15,771 | 108 |
| Corporate | 1,445 | 40 | - | - | 1,445 | 40 |
| Total | \$ 36,956 | \$ 290 | \$ 5,595 | \$ 47 | \$ 31,361 | \$ 243 |

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 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.

An other than temporary impairment expense of \$362,000 on Federal Home Loan Mortgage Corporation (“FHLMC”) and Federal National Mortgage Association (“FNMA”) perpetual preferred stock was charged to earnings in 2007. The market value of these two securities dropped significantly at the end of 2007, and any near-term recovery in value was considered uncertain as of December 31, 2007. The Company’s recorded investment in these securities, after the impairment charge, was \$1,346,000 at December 31, 2007.

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The table below 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 December 31, 2006.

| (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 | \$ 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 4 – Loans

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

| (in thousands) | December 31, | |
|-----------------------------------|-------------------|-------------------|
| | 2007 | 2006 |
| Construction and land development | \$ 69,803 | \$ 69,404 |
| Commercial real estate | 198,332 | 186,639 |
| Residential real estate | 133,899 | 131,126 |
| Home equity | 48,313 | 52,531 |
| Total real estate | 450,347 | 439,700 |
| Commercial and industrial | 91,028 | 91,511 |
| Consumer | 10,016 | 11,017 |
| Total loans | \$ 551,391 | \$ 542,228 |

Net deferred loan costs included in the above loan categories are \$171,000 for 2007 and \$68,000 for 2006.

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

| (in thousands) | December 31, | |
|---|-----------------|-----------------|
| | 2007 | 2006 |
| Impaired loans with a valuation allowance | \$ 3,092 | \$ 472 |
| Impaired loans without a valuation allowance | 473 | 904 |
| Total impaired loans | \$ 3,565 | \$ 1,376 |
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ 1,499 | \$ 241 |
| Nonaccrual loans excluded from the impaired loan disclosure | \$ 1,329 | \$ 2,311 |

| (in thousands) | Years Ended December 31, | | |
|----------------|--------------------------|------|------|
| | 2007 | 2006 | 2005 |

| | | | | | | |
|--|----|-------|----|-------|----|-------|
| Average balance in impaired loans | \$ | 2,540 | \$ | 2,534 | \$ | 6,043 |
| Interest income recognized on impaired loans | \$ | 262 | \$ | 121 | \$ | 105 |
| Interest income recognized on nonaccrual loans | \$ | - | \$ | - | \$ | 73 |
| Loans past due 90 days and still accruing interest | \$ | - | \$ | - | \$ | 56 |

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

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

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Note 5 – Accounting for Certain Loans Acquired in a Transfer

The Company acquired loans pursuant to the acquisition of Community First Financial Corporation (“Community First”) in April 2006. In accordance with SOP 03-3, at acquisition the Company reviewed each loan to determine whether there was evidence of deterioration of credit quality since origination and if it was probable that it will be unable to collect all amounts due according to the loan’s contractual terms. When both conditions existed, the Company accounted for each loan individually, considered expected prepayments, and estimated the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan. The Company determined the excess of the loan’s scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount, representing the excess of the loan’s cash flows expected to be collected over the amount paid, is accreted into interest income over the remaining life of the loan (accretable yield).

Over the life of the loan, the Company continues to estimate cash flows expected to be collected. The Company evaluates at the balance sheet date whether the present value of its loans determined using the effective interest rates has decreased and if so, establishes a valuation allowance for the loan. Valuation allowances for acquired loans subject to SOP 03-3 reflect only those losses incurred after acquisition – that is, the present value of cash flows expected at acquisition that are not expected to be collected. Valuation allowances are established only subsequent to acquisition of the loans. For loans that are not accounted for as debt securities, the present value of any subsequent increase in the loan’s or pool’s actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan. For any remaining increases in cash flows expected to be collected, the Company adjusts the amount of accretable yield recognized on a prospective basis over the loan’s remaining life. The Company does not have any such loans that were accounted for as debt securities.

Loans that were acquired in the Community First acquisition, for which there was evidence of deterioration of credit quality since origination and for which it was probable that all contractually required payments would not be made had an outstanding balance of \$1,010,000 and a carrying amount \$582,000 at December 31, 2007 and an outstanding balance of \$2,411,000 and a carrying amount of \$1,351,000 at December 31, 2006.

The carrying amount of these loans is included in the balance sheet amount of loans receivable at December 31, 2007 and 2006. These loans are not included in the impaired loan amounts disclosed in Note 4.

| (in thousands) | Accretable Yield |
|---|---------------------|
| Balance at December 31, 2005 | \$ - |
| Additions | 865 |
| Accretion | (159) |
| Reclassifications from (to) nonaccretable difference | (14) |
| Disposals | - |
| Balance at December 31, 2006 | 692 |
| Additions | - |
| Accretion | (52) |

| | |
|---|--------|
| Reclassifications from (to) nonaccretable difference | 1 |
| Disposals | (530) |
| Balance at December 31, 2007 | \$ 111 |

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Note 6 – 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 each of the years in the three-year period ended December 31, 2007, are presented below:

| (in thousands) | Years Ended December 31, | | |
|--|--------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Allowance for Loan Losses | | | |
| Balance, beginning of year | \$ 7,264 | \$ 6,109 | \$ 7,982 |
| Allowance acquired in merger | - | 1,598 | - |
| Provision for loan losses | 403 | 58 | 465 |
| Charge-offs | (515) | (913) | (2,577) |
| Recoveries | 243 | 412 | 239 |
| Balance, end of year | \$ 7,395 | \$ 7,264 | \$ 6,109 |
| Reserve for unfunded lending commitments | | | |
| Years Ended December 31, | | | |
| | 2007 | 2006 | 2005 |
| Balance, beginning of year | \$ 123 | \$ - | \$ - |
| Provision for unfunded commitments | 28 | 123 | - |
| Balance, end of year | \$ 151 | \$ 123 | \$ - |

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

Note 7 – Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

| (in thousands) | December 31, | |
|-----------------------------|--------------|-----------|
| | 2007 | 2006 |
| Land | \$ 3,977 | \$ 2,933 |
| Buildings | 11,573 | 11,542 |
| Leasehold improvements | 492 | 492 |
| Furniture and equipment | 13,210 | 12,226 |
| | 29,252 | 27,193 |
| Accumulated depreciation | (15,904) | (14,755) |
| Premises and equipment, net | \$ 13,348 | \$ 12,438 |

Depreciation expense for the years ended December 31, 2007, 2006, and 2005 was \$1,178,000, \$993,000 and \$866,000, respectively.

The Company has entered into operating leases for several of its branch and ATM facilities. The minimum annual rental payments under these leases at December 31, 2007 are as follows:

| (in thousands) | Minimum Lease Payments |
|----------------|------------------------|
| Year | |
| 2008 | \$ 311 |

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| | |
|----------------|--------|
| 2009 | 268 |
| 2010 | 217 |
| 2011 | 75 |
| 2012 | 42 |
| 2013 and after | 10 |
| | \$ 923 |

Rent expense for the years ended December 31, 2007, 2006, and 2005 was \$353,000, \$308,000, and \$187,000, respectively.

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Note 8– 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 test. A fair value-based test was performed during the third quarter of 2007 that determined the market value of the Company's shares exceeds the consolidated carrying value, including goodwill; therefore, there has been no impairment recognized in the value of goodwill.

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

| | |
|---------------------------------|-----------|
| Balance as of January 1, 2007 | \$ 22,468 |
| Goodwill recorded during year | - |
| Impairment losses | - |
| Balance as of December 31, 2007 | \$ 22,468 |

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 previous branch acquisitions were fully amortized during 2006.

The gross carrying amounts and accumulated amortization of core deposit intangibles as of December 31, 2007 and 2006 are as follows:

| (in thousands) | December 31, 2007 | | December 31, 2006 | |
|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Core deposit intangibles | \$ 7,616 | \$ (5,164) | \$ 7,616 | \$ (4,787) |

The following table sets forth the actual and estimated future amortization expense of core deposit intangibles:

| | |
|---|--------|
| Amortization Expense for the Year Ended December 31, 2007: | \$ 377 |
| Estimated Amortization Expense for the Year Ending December 31: | |
| 2008 | \$ 377 |
| 2009 | 377 |

| | |
|------------|-----|
| 2010 | 377 |
| 2011 | 377 |
| 2012 | 377 |
| Thereafter | 567 |

Note 9 - Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2007 and 2006 was \$101,212,000 and \$85,858,000 respectively.

At December 31, 2007, the scheduled maturities of certificates of deposits (included in “time” deposits on the Consolidated Balance Sheet) were as follows:

| | |
|----------------|------------|
| (in thousands) | |
| 2008 | \$ 203,919 |
| 2009 | 27,267 |
| 2010 | 12,046 |
| 2011 | 16,638 |
| 2012 | 4,560 |
| Thereafter | 155 |
| | \$ 264,585 |

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Note 10 – Borrowed Funds

Borrowed funds consist of customer repurchase agreements, overnight borrowings from the FHLB, advances from the FHLB, and trust preferred capital notes. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. Overnight FHLB borrowings contain floating interest rates that may change daily at the discretion of the FHLB. FHLB advances, as of December 31, 2007 and 2006, contained fixed rates of interest through the maturity date.

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of December 31, 2007, \$100,878,000 in 1-4 family residential mortgage loans was pledged under the blanket floating lien agreement. At December 31, 2007, principal obligations to the FHLB consisted of \$7,200,000 in floating-rate, overnight borrowings and \$8,937,000 in fixed-rate, long term advances. Principal obligations to the FHLB at December 31, 2006 consisted solely of fixed-rate, long term advances. Information pertaining to the fixed-rate, long term advances as of both those dates are as follows:

(dollars in thousands)

| Due by December 31 | 2007 Advance Amount | Weighted Average Rate | Due by December 31 | 2006 Advance Amount | Weighted Average Rate |
|--------------------------|---------------------------|-----------------------------|--------------------------|---------------------------|-----------------------------|
| 2008 | \$ 3,000 | 5.51% | 2007 | \$ 1,000 | 4.33% |
| 2009 | 5,000 | 5.26 | 2008 | 8,000 | 5.25 |
| 2014 | 937 | 3.78 | 2009 | 5,000 | 5.26 |
| | \$ 8,937 | 5.19% | 2014 | 1,087 | 3.78 |
| | | | | \$ 15,087 | 4.80% |

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

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of \$619,000 received by the Trust from the issuance of common securities by the Trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a Junior Subordinated Indenture entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company, and for general corporate purposes. In accordance with FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, the Corporation did not eliminate through consolidation the Corporation's \$619,000 equity investment in AMNB Statutory Trust I. Instead, the Corporation reflected this equity investment in the "Trust Preferred Capital Notes" line item in the

consolidated balance sheets.

Note 11 – Stock-Based Compensation

The Company's 1997 Stock Option Plan ("Option Plan") provided for the granting of incentive and non-statutory options to employees on a periodic basis, at the discretion of the Board or a Board designated committee. The Option Plan authorized the issuance of up to 300,000 shares of common stock.

There were no options granted since 2004, and, effective December 31, 2006, no further options may be granted under this plan.

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Effective January 1, 2006, the Company adopted SFAS 123R, Share Based Payment, using the modified prospective method and as such, results for prior periods have not been restated. All options were fully vested prior to January 1, 2006; therefore, adoption of SFAS 123R resulted in no compensation expense. There was no tax benefit associated with stock option activity during 2007, 2006, or 2005. 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.

No options were granted in 2005. Therefore, had the Company applied the fair value recognition provision of SFAS 123 to stock-based compensation prior to the January 1, 2006 adoption date, there would have been no effect on reported net income and earnings per share.

A summary of stock option transactions under the Option Plan follows:

| | Option Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (\$000) |
|-------------------------------------|------------------|--|---|--|
| Outstanding at December 31, 2006 | 201,849 | \$ 21.15 | 4.8 years | \$ 765 |
| Granted | - | - | | |
| Exercised | (18,752) | 15.75 | | |
| Forfeited | (8,226) | 14.00 | | |
| Outstanding at December 31, 2007 | 174,871 | \$ 21.15 | 4.3 years | \$ 263 |
| Exercisable at December 31, 2007 | 174,871 | \$ 21.15 | 4.3 years | \$ 263 |

The total intrinsic value of options exercised during 2007 was \$306,000.

The following table summarizes information related to stock options outstanding on December 31, 2007:

| Range of Exercise Prices | Number of Outstanding Options | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Number of Options Exercisable |
|-----------------------------|-------------------------------------|---|---------------------------------------|-------------------------------------|
| \$ 13.38 to 15.00 | 29,338 | 1.3 yrs | \$ 13.69 | 29,338 |
| 15.01 to 20.00 | 52,506 | 2.4 | 18.48 | 52,506 |
| 20.01 to 25.00 | 54,400 | 6.8 | 24.18 | 54,400 |
| 25.01 to 26.20 | 38,627 | 5.8 | 26.18 | 38,627 |
| | 174,871 | 4.3 yrs | \$ 21.15 | 174,871 |

Note 12 – Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the states of Virginia and North Carolina. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2004.

The Company adopted the provisions of FIN 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007, with no impact on the financial statements.

The components of the Company's net deferred tax assets were as follows:

| (in thousands) | December 31, | |
|--|--------------|----------|
| | 2007 | 2006 |
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 2,476 | \$ 2,398 |
| Accrued pension benefit | 243 | 0 |
| Nonaccrual loan interest | 175 | 134 |
| Deferred compensation | 217 | 232 |
| Preferred stock impairment, net of valuation allowance | 294 | 261 |
| Net unrealized losses on securities | - | 379 |
| Loans | 607 | 1,017 |
| Other | 7 | 56 |
| Total deferred tax assets | \$ 4,019 | \$ 4,477 |

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| | December 31, | |
|--------------------------------------|--------------|----------|
| | 2007 | 2006 |
| Deferred tax liabilities: | | |
| Depreciation | \$ 806 | \$ 847 |
| Accretion of discounts on securities | 33 | 27 |
| Core deposit intangibles | 535 | 562 |
| Deferred loan fees | 60 | 24 |
| Net unrealized gains on securities | 574 | - |
| Prepaid pension expense | - | 11 |
| Unrealized pension liability | 812 | 789 |
| Other | 178 | 287 |
| Total deferred tax liabilities | 2,998 | 2,547 |
| Net deferred tax assets | \$ 1,021 | \$ 1,930 |

The provision for income taxes consists of the following:

| (in thousands) | Years Ended December 31, | | |
|-----------------------------------|--------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Taxes currently payable | \$ 4,943 | \$ 4,387 | \$ 3,528 |
| Deferred tax expense (benefit) | (67) | 732 | 569 |
| | \$ 4,876 | \$ 5,119 | \$ 4,097 |

The effective tax rates differ from the statutory federal income tax rates due to the following items:

| | Years Ended December 31, | | |
|----------------------------|--------------------------|-------|-------|
| | 2007 | 2006 | 2005 |
| Federal statutory rate | 34.4% | 34.4% | 34.3% |
| Nontaxable interest income | (3.5) | (3.7) | (5.0) |
| Other | (1.0) | 0.2 | (0.2) |
| Effective rate | 29.9% | 30.9% | 29.1% |

Note 13 – 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.

| | Years Ended December 31, | | | | | |
|------------------------------|--------------------------|------------------|-----------|------------------|-----------|------------------|
| | 2007 | | 2006 | | 2005 | |
| | Shares | Per Share Amount | Shares | Per Share Amount | Shares | Per Share Amount |
| B a s i c earnings per share | 6,139,095 | \$ 1.86 | 5,986,262 | \$ 1.91 | 5,465,090 | \$ 1.83 |
| E f f e c t o f dilutive | 22,730 | - | 33,809 | (.01) | 41,908 | (.02) |

securities -
 stock
 options

| | | | | | | |
|----------------------------|-----------|---------|-----------|---------|-----------|---------|
| Diluted earnings per share | 6,161,825 | \$ 1.86 | 6,020,071 | \$ 1.90 | 5,506,998 | \$ 1.81 |
|----------------------------|-----------|---------|-----------|---------|-----------|---------|

Stock options on common stock which were not included in computing diluted EPS in 2007, 2006, and 2005, because their effects were antidilutive averaged 89,277 shares, 88,177 shares, and 97,344 shares, respectively.

Note 14 – Off-Balance Sheet Activities

The Company is party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if applicable, is based on management's credit evaluation of the customer.

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The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

The following off-balance sheet financial instruments were outstanding whose contract amounts represent credit risk:

| (in thousands) | December 31, | |
|------------------------------|--------------|------------|
| | 2007 | 2006 |
| Commitments to extend credit | \$ 144,301 | \$ 155,038 |
| Standby letters of credit | 6,222 | 3,125 |
| R a t e l o c k commitments | 2,215 | 2,246 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally consist of unused portions of lines of credit issued to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

At December 31, 2007, the Company had entered into commitments, on a best-effort basis, to sell loans of approximately \$3,583,000. These commitments include mortgage loan commitments and loans held for sale. Risks arise from the possible inability of counterparties to meet the terms of their contracts.

Note 15 – Related Party Loans

In the ordinary course of business, loans are granted to executive officers, directors, and their related entities. Management believes that all such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to similar, unrelated borrowers, and do not involve more than a normal risk of collectability or present other unfavorable features. As of December 31, 2007, none of these loans were restructured, past due, or on nonaccrual status.

An analysis of these loans for 2007 is as follows (in thousands):

| | |
|------------------------------|-----------|
| Balance at beginning of year | \$ 18,156 |
| Additions | 19,080 |
| Repayments | (16,954) |
| Balance at end of year | \$ 20,282 |

Note 16 – Employee Benefit Plans

Defined Benefit Plan

The Company maintains a non-contributory defined benefit pension plan which covers substantially all employees who are 21 years of age or older and who have had at least one year of service. Advanced funding is accomplished by using the actuarial cost method known as the collective aggregate cost method. The Company uses October 31 as a measurement date to determine postretirement benefit obligations. The requirement to measure plan assets and benefit obligations as of the date of the employers' fiscal year-end statement of financial position under SFAS 158 is effective for fiscal years ending after December 15, 2008.

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The following table sets forth the plan's status and related disclosures as required by SFAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106, and 132(R):

| (in thousands) | As of and for the Years Ended December 31, | | |
|---|--|----------|------------|
| | 2007 | 2006 | 2005 |
| Change in benefit obligation: | | | |
| Projected benefit obligation at beginning of year | \$ 7,038 | \$ 7,225 | \$ 6,628 |
| Service cost | 656 | 621 | 438 |
| Interest cost | 418 | 351 | 367 |
| Plan amendments | - | 101 | (113) |
| Actuarial loss | 987 | 6 | 734 |
| Benefits paid | (176) | (1,266) | (829) |
| Projected benefit obligation at end of year | \$ 8,923 | \$ 7,038 | \$ 7,225 |
| Change in plan assets: | | | |
| Fair value of plan assets at beginning of year | \$ 7,070 | \$ 6,056 | \$ 6,276 |
| Actual return on plan assets | 1,336 | 780 | 277 |
| Employer contributions | - | 1,500 | 332 |
| Benefits paid | (176) | (1,266) | (829) |
| Fair value of plan assets at end of year | \$ 8,230 | \$ 7,070 | \$ 6,056 |
| Funded status at end of year | \$ (693) | \$ 32 | \$ (1,169) |
| Amounts recognized in the Consolidated Balance Sheets | | | |
| Other assets (liabilities) | \$ (693) | \$ 32 | \$ 1,425 |
| Amounts Recognized in Accumulated Other Comprehensive Loss | | | |
| Net loss | \$ 2,308 | \$ 2,243 | N/A |
| Prior service cost | 12 | 11 | N/A |
| Deferred income tax benefit | (812) | (789) | N/A |
| Amount recognized | \$ 1,508 | \$ 1,465 | N/A |
| Funded Status | | | |
| Benefit obligation | N/A | N/A | \$ (7,225) |
| Fair value of assets | N/A | N/A | 6,056 |
| Unrecognized net actuarial loss | N/A | N/A | 2,708 |
| Unrecognized net obligation at transition | N/A | N/A | - |
| Unrecognized prior service cost | N/A | N/A | (114) |
| Prepaid benefit cost included in other assets before adoption of SFAS 158 | N/A | N/A | \$ 1,425 |
| Components of Net Periodic Benefit Cost | | | |
| Service cost | \$ 656 | \$ 621 | \$ 438 |
| Interest cost | 418 | 351 | 367 |
| Expected return on plan assets | (564) | (521) | (502) |
| Amortization of prior service cost | (1) | (23) | (34) |
| Recognized net actuarial loss | 150 | 211 | 83 |
| Net periodic benefit cost | \$ 659 | \$ 639 | \$ 352 |

Other Changes in Plan Assets and Benefit

Obligations Recognized in Other Comprehensive

Loss

| | | | | | |
|--|----|------|----|-------|-----|
| Net loss | \$ | 65 | \$ | 2,243 | N/A |
| Prior service cost | | - | | 11 | N/A |
| Amortization of prior service cost | | 1 | | - | N/A |
| Deferred tax benefit | | (23) | | (789) | N/A |
| Total recognized in other comprehensive loss | \$ | 43 | \$ | 1,465 | N/A |

Total Recognized in Net Periodic Benefit Cost

| | | | | | | |
|--------------------------------|----|-----|----|-------|----|-----|
| and Other Comprehensive Income | \$ | 702 | \$ | 2,104 | \$ | 352 |
|--------------------------------|----|-----|----|-------|----|-----|

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| | As of and for the Years Ended December 31, | | |
|--|--|-------|-------|
| | 2007 | 2006 | 2005 |
| Weighted-average assumptions at end of year | | | |
| Discount rate used for net periodic pension cost | 6.00% | 5.75% | 6.00% |
| Discount rate used for disclosure | 6.00% | 6.00% | 5.75% |
| Expected return on plan assets | 8.00% | 8.00% | 8.00% |
| N/A – not applicable | | | |

The accumulated benefit obligation as of December 31, 2007, 2006, and 2005 was \$6,499,448, \$4,971,000, and \$5,300,000 respectively.

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

Below is a description of the plan's assets. The plan's weighted-average asset allocations by asset category are as follows:

| Asset Category | October 31, 2007 | October 31, 2006 |
|----------------|------------------|------------------|
| Fixed Income | 25.0% | 31.6 |
| Equity | 63.7 | 66.9 |
| Other | 11.3 | 1.5 |
| Total | 100.0% | 100.0 |

The investment policy and strategy for plan assets can best be described as a growth and income strategy. Diversification is accomplished by limiting the holding of any one equity issuer to no more than 5% of total equities. Exchange traded funds are used to provide diversified exposure to the small capitalization and international equity markets. All fixed income investments are rated as investment grade, with the majority of these assets invested in corporate issues. The assets are managed by the Company's Trust and Investment Services Division. No derivatives are used to manage the assets. Equity securities do not include holdings in the Company.

Projected benefit payments for the years 2008 to 2017 are as follows (in thousands):

| Year | Amount |
|------|--------|
| 2008 | \$ 29 |

| | |
|-----------|-------|
| 2009 | 42 |
| 2010 | 89 |
| 2011 | 211 |
| 2012 | 253 |
| 2013-2017 | 1,980 |

The Company's maximum estimated contribution for 2008 is \$2 million.

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Defined Contribution Plan

The Company maintains a 401(k) savings plan that covers substantially all full-time employees of the Company. The Company matches a portion of the contribution made by employee participants after at least one year of service. The Company contributed \$273,000, \$245,000, and \$166,000 to the 401(k) plan in 2007, 2006, and 2005, respectively. These amounts are included in pension and other employee benefits expense for the respective years.

Deferred Compensation Arrangements

The Company maintains deferred compensation agreements with certain current and former employees providing for annual payments to each ranging from \$25,000 to \$50,000 per year for ten years upon their retirement. The liabilities under these agreements are being accrued over the officers' remaining periods of employment so that, on the date of their retirement, the then-present value of the annual payments would have been accrued. The expense for these agreements was \$55,000, \$60,000, and \$64,000 for years 2007, 2006, and 2005, respectively.

Profit Sharing and Incentive Arrangements

The Company maintains a cash profit sharing plan for full-time employees based on the Company's performance and a cash incentive compensation plan for officers based on the Company's performance and individual officer goals. The total amount charged to salary expense for these plans was \$287,000, \$867,000, and \$866,000 for the years 2007, 2006, and 2005, respectively.

Note 17 – Fair Value of Financial Instruments

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. 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. SFAS 107, Disclosures About Fair Value of Financial Instruments, excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The estimated fair values of the Company's assets are as follows:

| (in thousands) | December 31, 2007 | | December 31, 2006 | |
|----------------------------------|--------------------|----------------------------|--------------------|----------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and due from banks | \$ 18,304 | \$ 18,304 | \$ 26,124 | \$ 26,124 |
| Securities available for sale | 145,159 | 145,159 | 148,748 | 148,748 |
| Securities held to maturity | 11,990 | 12,250 | 13,873 | 14,131 |
| Loans held for sale | 1,368 | 1,368 | 1,662 | 1,662 |
| Loans, net of allowance | 543,996 | 550,458 | 534,964 | 530,373 |

| | | | | |
|-------------------------------|------------|------------|------------|------------|
| Accrued interest receivable | 3,547 | 3,547 | 3,862 | 3,862 |
| Financial liabilities: | | | | |
| Deposits | \$ 581,221 | \$ 581,726 | \$ 608,528 | \$ 606,466 |
| Repurchase agreements | 47,891 | 47,891 | 33,368 | 33,368 |
| Other borrowings | 16,137 | 15,850 | 15,087 | 17,017 |
| Trust preferred capital notes | 20,619 | 20,155 | 20,619 | 20,619 |
| Accrued interest payable | 1,722 | 1,722 | 1,683 | 1,683 |

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. The carrying value of restricted stock approximates fair value.

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

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

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

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

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

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

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

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

Off balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2007 and 2006, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the table above.

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 18 – Dividend Restrictions and Regulatory Capital

The approval of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the bank's net income, as defined, for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Company's bank subsidiary can distribute as dividends, without the approval of the Comptroller of the Currency, \$7,864,000 as of December 31, 2007.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are subject to qualitative judgments by the regulators concerning components, risk weighting, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under the guidelines, total capital is defined as core (Tier I) capital and supplementary (Tier II) capital. The Company's Tier I capital consists primarily of shareholders' equity and trust preferred capital notes, while Tier II capital also includes the allowance for loan losses subject to certain limits. The definition of assets has been modified to include items on and off the balance sheet, with each item being assigned a "risk-weight" for the determination of the ratio of capital to risk-adjusted assets. Management believes, as of December 31, 2007 and 2006, that the Company met the requirements to be considered "well capitalized."

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The following table provides summary information regarding regulatory capital:

| (in thousands) | Actual | | Minimum Capital Requirement | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|-------------------|------------|--------|-----------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2007 | | | | | | |
| Total Capital | | | | | | |
| Company | \$ 104,179 | 18.28% | \$ 45,593 | >8.0% | | |
| Bank | 93,961 | 16.49 | 45,581 | >8.0 | \$ 56,976 | >10.0% |
| Tier I Capital | | | | | | |
| Company | 97,033 | 17.03 | 22,797 | >4.0 | | |
| Bank | 87,806 | 15.41 | 22,791 | >4.0 | 34,186 | >6.0 |
| Leverage Capital | | | | | | |
| Company | 97,033 | 12.98 | 29,912 | >4.0 | | |
| Bank | 87,806 | 11.76 | 29,862 | >4.0 | 37,328 | >5.0 |
| December 31, 2006 | | | | | | |
| Total Capital | | | | | | |
| Company | \$ 99,074 | 17.45% | \$ 45,410 | >8.0% | | |
| Bank | 93,257 | 16.43 | 45,402 | >8.0 | \$ 56,752 | >10.0% |
| Tier I Capital | | | | | | |
| Company | 91,863 | 16.18 | 22,705 | >4.0 | | |
| Bank | 86,976 | 15.33 | 22,701 | >4.0 | 34,051 | >6.0 |
| Leverage Capital | | | | | | |
| Company | 91,863 | 12.15 | 30,241 | >4.0 | | |
| Bank | 86,976 | 11.53 | 30,181 | >4.0 | 37,726 | >5.0 |

Note 19 – 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, 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. 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. Refer to Note 10 for additional information on the AMNB Statutory Trust I. 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.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. All intersegment sales prices are market based.

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Segment information as of and for the years ended December 31, 2007, 2006, and 2005, is shown in the following table:

| (in thousands) | 2007 | | | | | Total |
|---|-------------------|-------------------------------|---------|---------------------------|------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | | |
| Interest income | \$ 48,597 | \$ - | \$ - | \$ - | \$ - | \$ 48,597 |
| Interest expense | 17,997 | - | 1,373 | - | - | 19,370 |
| Noninterest income - external customers | 4,623 | 4,128 | 71 | - | - | 8,822 |
| Operating income before income taxes | 15,615 | 2,234 | (1,529) | - | - | 16,320 |
| Depreciation and amortization | 1,528 | 25 | 2 | - | - | 1,555 |
| Total assets | 771,518 | - | 770 | - | - | 772,288 |
| Capital expenditures | 2,087 | 18 | - | - | - | 2,105 |

| (in thousands) | 2006 | | | | | Total |
|---|-------------------|-------------------------------|---------|---------------------------|------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | | |
| Interest income | \$ 45,060 | \$ - | \$ 10 | \$ - | \$ - | \$ 45,070 |
| Interest expense | 15,629 | - | 1,032 | - | - | 16,661 |
| Noninterest income - external customers | 4,623 | 3,793 | 42 | - | - | 8,458 |
| Operating income before income taxes | 15,747 | 1,963 | (1,165) | - | - | 16,545 |
| Depreciation and amortization | 1,383 | 22 | 2 | - | - | 1,407 |
| Total assets | 777,001 | - | 719 | - | - | 777,720 |
| Capital expenditures | 1,044 | 1 | - | - | - | 1,045 |

| (in thousands) | 2005 | | | | | Total |
|---|-------------------|-------------------------------|-------|---------------------------|------|-----------|
| | Community Banking | Trust and Investment Services | Other | Intersegment Eliminations | | |
| Interest income | \$ 32,479 | \$ - | \$ - | \$ - | \$ - | \$ 32,479 |
| Interest expense | 8,740 | - | - | - | - | 8,740 |
| Noninterest income - external customers | 4,483 | 3,397 | 16 | - | - | 7,896 |
| Noninterest income - internal customers | - | 36 | - | (36) | - | - |
| Operating income before income taxes | 12,822 | 1,455 | (186) | - | - | 14,091 |
| Depreciation and amortization | 1,194 | 22 | 2 | - | - | 1,219 |
| Total assets | 622,468 | - | 1,035 | - | - | 623,503 |
| Capital expenditures | 1,062 | 59 | - | - | - | 1,121 |

Note 20 – Parent Company Financial Information

Condensed Parent Company financial information is as follows (in thousands):

| Condensed Balance Sheets | December 31, | |
|---|--------------|------------|
| | 2007 | 2006 |
| Cash | \$ 8,619 | \$ 4,452 |
| Investment in subsidiaries | 112,903 | 110,724 |
| Other assets | 671 | 571 |
| Total Assets | \$ 122,193 | \$ 115,747 |
| Trust preferred capital notes | \$ 20,619 | \$ 20,619 |
| Other liabilities | 63 | 136 |
| Shareholders' equity | 101,511 | 94,992 |
| Total Liabilities and Shareholders' Equity | \$ 122,193 | \$ 115,747 |

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| Condensed Statements of Income | Years Ended December 31, | | |
|--|--------------------------|-----------|----------|
| | 2007 | 2006 | 2005 |
| Dividends from subsidiary | \$ 12,000 | \$ 7,900 | \$ 7,000 |
| Other income | 86 | 52 | 16 |
| Expenses | 1,615 | 1,217 | 201 |
| Income taxes (benefit) | (520) | (396) | (63) |
| Income before equity in undistributed earnings of subsidiary | 10,991 | 7,131 | 6,878 |
| Equity in undistributed earnings of subsidiary | 453 | 4,295 | 3,116 |
| Net Income | \$ 11,444 | \$ 11,426 | \$ 9,994 |

| Condensed Statements of Cash Flows | Years Ended December 31, | | |
|---|--------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Cash provided by dividends received from subsidiary | \$ 12,000 | \$ 7,900 | \$ 7,000 |
| Cash used for payment of dividends | (5,587) | (5,210) | (4,529) |
| Cash used for repurchase of stock | (1,359) | (912) | (2,404) |
| Proceeds from exercise of options | 295 | 171 | 303 |
| Other | (1,182) | 1,535 | (204) |
| Net increase in cash | \$ 4,167 | \$ 3,484 | \$ 166 |

Note 21 – Concentrations of Credit Risk

Substantially all the Company's loans are made within its market area, which includes Southern and Central Virginia and the northern portion of Central North Carolina. The ultimate collectability of the Company's loan portfolio and the ability to realize the value of any underlying collateral, if necessary, are impacted by the economic conditions of the market area.

Loans secured by real estate were \$450,347,000, or 82% of the loan portfolio, at December 31, 2007, and \$439,700,000, or 81% of the loan portfolio, at December 31, 2006. Loans secured by commercial real estate represented the largest portion of loans at \$198,300,000 at December 31, 2007, and \$186,600,000 at December 31, 2006, 36% and 34%, respectively of total loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2007 or 2006, loans to lessors of nonresidential buildings represented 11.0% of total loans at December 31, 2007; the lessees and lessors are engaged in a variety of industries.

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Note 22 – Supplemental Cash Flow Information

| (Dollars in thousands) | For The Years Ended December 31, | | |
|--|----------------------------------|-----------|-----------|
| | 2007 | 2006 | 2005 |
| Supplemental Schedule of Cash and Cash Equivalents: | | | |
| Cash and due from banks | \$ 18,155 | \$ 24,375 | \$ 18,300 |
| Interest-bearing deposits in other banks | 149 | 1,749 | 9,054 |
| | \$ 18,304 | \$ 26,124 | \$ 27,354 |
| Supplemental Disclosure of Cash Flow Information: | | | |
| Cash paid for: | | | |
| Interest on deposits and borrowed funds | \$ 19,332 | \$ 14,906 | \$ 8,479 |
| Income taxes | 3,790 | 3,738 | 4,452 |
| Noncash investing and financing activities: | | | |
| Transfer of loans to other real estate owned | 498 | 115 | 62 |
| Unrealized gain (loss) on securities available for sale | 2,723 | 8 | (1,431) |
| Transactions related to the merger acquisition: | | | |
| Increase in assets and liabilities | | | |
| Cash and due from banks | \$ - | \$ 2,956 | \$ - |
| Securities | - | 8,020 | - |
| Loans, net | - | 134,217 | - |
| Bank premises and equipment, net | - | 4,930 | - |
| Goodwill and core deposit intangibles | - | 25,580 | - |
| Accrued interest receivable and other assets | - | 5,481 | - |
| Demand deposits--noninterest bearing | - | 21,376 | - |
| Demand deposits--interest bearing | - | 120,596 | - |
| Borrowings | - | 2,500 | - |
| Accrued interest payable and other liabilities | - | 2,079 | - |
| Issuance of common stock | - | 17,546 | - |

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PART IV

- (a)(1) Financial Statements (See Item 8 for reference)
(a)(3) Exhibits

EXHIBIT INDEX

| Exhibit # | | Location |
|-----------|---|---|
| 2.1 | Agreement and Plan of Reorganization, as of October 18, 2005, between American National Bankshares Inc. and Community First Financial Corporation | Exhibit 2.1 on Form 8-K filed October 20, 2005 |
| 3.1 | Amended and Restated Articles of Incorporation Dated August 20, 1997 | Exhibit 4.1 on Form S-3 filed August 20, 1997 |
| 3.2 | Amended Bylaws dated December 18, 2007 | Exhibit 3.2 on Form 8-K filed December 18, 2007 |
| 10.1 | Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Charles H. Majors dated December 18, 2001 | Exhibit 10.5 on Form 10-K filed March 25, 2002 |
| 10.1 | Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Jeffrey V. Haley dated December 18, 2001 | Exhibit 10.8 on Form 10-K filed March 25, 2002 |
| 10.3 | Agreement between American National Bank and Trust Company, and Charles H. Majors dated January 1, 2002 | Exhibit 10.10 on Form 10-K filed March 25, 2002 |
| 10.4 | Agreement between American National Bankshares Inc., American National Bank and Trust Company, and R. Helm Dobbins dated June 17, 2003 | Exhibit 10.1 on Form 10-K filed March 16, 2005 |
| 10.5 | Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Neal A. Petrovich dated June 15, 2004 | Exhibit 10.2 on Form 10-K filed March 16, 2005 |
| 11.1 | <u>Refer to EPS calculation in the Notes to Financial Statements</u> | Filed herewith |
| 21.1 | <u>Subsidiaries of the registrant</u> | Filed herewith |
| 31.1 | <u>Section 302 Certification of Charles H. Majors, President and CEO</u> | Filed herewith |
| 31.2 | <u>Section 302 Certification of Neal A. Petrovich, Senior Vice President and CFO</u> | Filed herewith |
| 32.1 | <u>Section 906 Certification of Charles H. Majors, President and CEO</u> | Filed herewith |

32.2

Section 906 Certification of Neal A. Petrovich, Senior Vice President and CFO Filed herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

March 10, 2008

AMERICAN NATIONAL BANKSHARES INC.

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 10, 2008.

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

/s/ Fred A. Blair Director
Fred A. Blair

/s/ Dr. Frank C. Crist, Jr. Director
Dr. Frank C. Crist, Jr.

/s/ Ben J. Davenport, Jr. Director
Ben J. Davenport, Jr.

/s/ H. Dan Davis Director
H. Dan Davis

/s/ Michael P. Haley Director
Michael P. Haley

/s/ Lester A. Hudson, Jr. Director
Lester A. Hudson, Jr., Ph.D.

/s/ E. Budge Kent, Jr. Director
E. Budge Kent, Jr.

/s/ Fred B. Leggett, Jr. Director
Fred B. Leggett, Jr.

/s/ Franklin W. Maddux Director
Franklin W. Maddux, M.D.

/s/ Claude B. Owen, Jr. Director
Claude B. Owen, Jr.

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

Principal Accounting Officer

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