

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

**FORM 10-Q**

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

Commission file number: 0-12820

**AMERICAN NATIONAL BANKSHARES INC.**

(Exact name of registrant as specified in its charter)

VIRGINIA

(State or other jurisdiction of  
incorporation or organization)

628 Main Street  
Danville, Virginia

(Address of principal executive offices)

54-1284688

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

24541

(Zip Code)

(434) 792-5111

(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

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

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

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

Yes  No

At November 7, 2012, the Company had 7,843,221 shares of Common Stock outstanding, \$1 par value.

AMERICAN NATIONAL BANKSHARES INC.

<u>Index</u>		<u>Page</u>
Part I.	FINANCIAL INFORMATION	
Item 1.	Financial Statements	
	Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011	3
	Consolidated Statements of Income for the three months ended September 30, 2012 and 2011	4
	Consolidated Statements of Income for the nine months ended September 30, 2012 and 2011	5
	Consolidated Statements of Comprehensive Income for the three months and nine months ended September 30, 2012 and 2011	6
	Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2012 and 2011	7
	Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011	8
	Notes to Consolidated Financial Statements	9
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	37
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	57
Item 4.	Controls and Procedures	57
Part II.	OTHER INFORMATION	
Item 1.	Legal Proceedings	58
Item 1A.	Risk Factors	58
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	58
Item 3.	Defaults Upon Senior Securities	58
Item 4.	Mine Safety Disclosures	58
Item 5.	Other Information	58
Item 6.	Exhibits	58
SIGNATURES		

Part I. Financial Information  
Item 1. Financial Statements

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

	(Unaudited) September 30, 2012	(Audited) December 31, 2011
<b>Assets</b>		
Cash and due from banks	\$ 25,740	\$ 22,561
Interest-bearing deposits in other banks	41,900	6,332
Securities available for sale, at fair value	327,994	333,366
Restricted stock, at cost	5,284	6,019
Loans held for sale	8,118	6,330
Loans, net of unearned income	797,818	824,758
Less allowance for loan losses	(11,998)	(10,529)
Net loans	<u>785,820</u>	<u>814,229</u>
Premises and equipment, net	24,885	25,674
Other real estate owned, net	6,259	5,353
Goodwill	39,043	38,899
Core deposit intangibles, net	5,081	6,595
Bank owned life insurance	13,380	13,058
Accrued interest receivable and other assets	22,203	26,290
Total assets	<u>\$ 1,305,707</u>	<u>\$ 1,304,706</u>
<b>Liabilities</b>		
Demand deposits -- noninterest bearing	\$ 215,012	\$ 179,148
Demand deposits -- interest bearing	152,706	189,212
Money market deposits	164,266	182,347
Savings deposits	78,665	74,193
Time deposits	441,778	433,854
Total deposits	<u>1,052,427</u>	<u>1,058,754</u>
Short-term borrowings:		
Customer repurchase agreements	45,761	45,575
Other short-term borrowings	-	3,000
Long-term borrowings	10,111	10,206
Trust preferred capital notes	27,292	27,212
Accrued interest payable and other liabilities	8,071	7,130
Total liabilities	<u>1,143,662</u>	<u>1,151,877</u>
<b>Shareholders' equity</b>		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 20,000,000 shares authorized, 7,843,221 shares outstanding at September 30, 2012 and 7,806,869 shares outstanding at December 31, 2011	7,843	7,807
Capital in excess of par value	57,045	56,395
Retained earnings	88,478	81,797
Accumulated other comprehensive income, net	8,679	6,830
Total shareholders' equity	<u>162,045</u>	<u>152,829</u>
Total liabilities and shareholders' equity	<u>\$ 1,305,707</u>	<u>\$ 1,304,706</u>

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

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

	Three Months Ended September 30	
	2012	2011
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 11,421	\$ 12,510
Interest and dividends on securities:		
Taxable	995	1,192
Tax-exempt	1,059	1,014
Dividends	52	35
Other interest income	19	28
Total interest and dividend income	<u>13,546</u>	<u>14,779</u>
<b>Interest Expense:</b>		
Interest on deposits	1,725	2,079
Interest on short-term borrowings	33	82
Interest on long-term borrowings	84	86
Interest on trust preferred capital notes	204	189
Total interest expense	<u>2,046</u>	<u>2,436</u>
<b>Net Interest Income</b>	11,500	12,343
Provision for Loan Losses	<u>333</u>	<u>525</u>
<b>Net Interest Income After Provision for Loan Losses</b>	<u>11,167</u>	<u>11,818</u>
<b>Noninterest Income:</b>		
Trust fees	926	921
Service charges on deposit accounts	414	575
Other fees and commissions	421	429
Mortgage banking income	615	374
Other	314	399
Total noninterest income	<u>2,690</u>	<u>2,698</u>
<b>Noninterest Expense:</b>		
Salaries	3,933	3,676
Employee benefits	780	731
Occupancy and equipment	929	916
FDIC assessment	84	94
Bank franchise tax	173	206
Core deposit intangible amortization	421	545
Foreclosed real estate, net	412	(32)
Merger related expenses	(30)	390
Other	2,178	2,038
Total noninterest expense	<u>8,880</u>	<u>8,564</u>
Income Before Income Taxes	4,977	5,952
Income Taxes	<u>1,338</u>	<u>1,823</u>
<b>Net Income</b>	3,639	4,129
Dividends on preferred stock	-	51
<b>Net income available to common shareholders</b>	<u>\$ 3,639</u>	<u>\$ 4,078</u>
<b>Net Income Per Common Share:</b>		
Basic	\$ 0.46	\$ 0.52
Diluted	\$ 0.46	\$ 0.52
<b>Average Common Shares Outstanding:</b>		
Basic	7,838,314	7,800,614
Diluted	7,855,537	7,806,668

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

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

	Nine Months Ended September 30	
	2012	2011
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 37,224	\$ 25,807
Interest and dividends on securities:		
Taxable	3,130	3,446
Tax-exempt	3,218	2,557
Dividends	155	88
Other interest income	47	112
Total interest and dividend income	<u>43,774</u>	<u>32,010</u>
<b>Interest Expense:</b>		
Interest on deposits	5,291	5,246
Interest on short-term borrowings	127	244
Interest on long-term borrowings	252	144
Interest on trust preferred capital notes	616	829
Total interest expense	<u>6,286</u>	<u>6,463</u>
<b>Net Interest Income</b>	37,488	25,547
Provision for Loan Losses	<u>1,799</u>	<u>1,198</u>
<b>Net Interest Income After Provision for Loan Losses</b>	<u>35,689</u>	<u>24,349</u>
<b>Noninterest Income:</b>		
Trust fees	2,774	2,727
Service charges on deposit accounts	1,315	1,396
Other fees and commissions	1,323	1,083
Mortgage banking income	1,665	792
Securities gains (losses), net	160	(18)
Other	<u>1,487</u>	<u>677</u>
Total noninterest income	<u>8,724</u>	<u>6,657</u>
<b>Noninterest Expense:</b>		
Salaries	11,853	8,707
Employee benefits	2,657	1,896
Occupancy and equipment	2,942	2,311
FDIC assessment	530	496
Bank franchise tax	538	557
Core deposit intangible amortization	1,514	734
Foreclosed real estate, net	430	174
Merger related expenses	19	1,534
Other	<u>7,157</u>	<u>4,646</u>
Total noninterest expense	<u>27,640</u>	<u>21,371</u>
Income Before Income Taxes	16,773	9,635
Income Taxes	<u>4,685</u>	<u>2,716</u>
<b>Net Income</b>	12,088	6,919
Dividends on preferred stock	-	51
<b>Net income available to common shareholders</b>	<u>\$ 12,088</u>	<u>\$ 6,868</u>
<b>Net Income Per Common Share:</b>		
Basic	\$ 1.54	\$ 1.02
Diluted	\$ 1.54	\$ 1.02
<b>Average Common Shares Outstanding:</b>		
Basic	7,830,928	6,705,607
Diluted	7,846,659	6,712,960

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

**American National Bankshares Inc. and Subsidiaries**  
**Consolidated Statements of Comprehensive Income**  
**September 30, 2012**  
(Dollars in thousands) (Unaudited)

	Three Months Ended September 30	
	2012	2011
Net income	\$ 3,639	\$ 4,129
Other comprehensive income:		
Unrealized gains on securities available for sale	2,396	4,336
Income tax (expense)	(838)	(1,517)
Other comprehensive income	1,558	2,819
Comprehensive income	<u>\$ 5,197</u>	<u>\$ 6,948</u>
	Nine Months Ended September 30	
	2012	2011
Net income	\$ 12,088	\$ 6,919
Other comprehensive income:		
Unrealized gains on securities available for sale	3,004	8,491
Income tax (expense)	(1,051)	(2,972)
Reclassification adjustment for (gains) losses on securities	(160)	18
Income tax expense (benefit)	56	(6)
Other comprehensive income	1,849	5,531
Comprehensive income	<u>\$ 13,937</u>	<u>\$ 12,450</u>

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

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

Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands) (Unaudited)

	Preferred Stock	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balance, December 31, 2010</b>	\$ -	\$ 6,128	\$ 27,268	\$ 74,850	\$ (159)	\$ 108,087
Net income	-	-	-	6,919	-	6,919
Other comprehensive income	-	-	-	-	5,531	5,531
Issuance of common stock	-	1,626	28,279	-	-	29,905
Issuance of preferred stock	5,000	-	-	-	-	5,000
Stock options exercised	-	11	162	-	-	173
Stock option expense	-	-	48	-	-	48
Equity based compensation	-	38	337	-	-	375
Dividends on preferred stock	-	-	-	(51)	-	(51)
Cash dividends declared, \$0.69 per share	-	-	-	(4,626)	-	(4,626)
<b>Balance, September 30, 2011</b>	<u>\$ 5,000</u>	<u>\$ 7,803</u>	<u>\$ 56,094</u>	<u>\$ 77,092</u>	<u>\$ 5,372</u>	<u>\$ 151,361</u>
<b>Balance, December 31, 2011</b>	\$ -	\$ 7,807	\$ 56,395	\$ 81,797	\$ 6,830	\$ 152,829
Net income	-	-	-	12,088	-	12,088
Other comprehensive income	-	-	-	-	1,849	1,849
Stock options exercised	-	7	111	-	-	118
Equity based compensation	-	29	539	-	-	568
Cash dividends declared, \$0.69 per share	-	-	-	(5,407)	-	(5,407)
<b>Balance, September 30, 2012</b>	<u>\$ -</u>	<u>\$ 7,843</u>	<u>\$ 57,045</u>	<u>\$ 88,478</u>	<u>\$ 8,679</u>	<u>\$ 162,045</u>

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

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

	2012	2011
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 12,088	\$ 6,919
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,799	1,198
Depreciation	1,315	770
Core deposit intangible amortization	1,514	734
Net amortization (accretion) of securities	2,480	1,086
Net accretion of fair value adjustments	(6,914)	(1,328)
Net (gain) loss on sale or call of securities	(160)	18
Gain on loans held for sale	(1,469)	(697)
Proceeds from sales of loans held for sale	70,077	32,503
Originations of loans held for sale	(70,396)	(31,917)
Net gain on foreclosed real estate	(170)	(185)
Valuation allowance on foreclosed real estate	279	359
Net gain on sale of premises and equipment	(504)	-
Stock-based compensation expense	-	48
Equity based compensation	568	375
Deferred income tax expense (benefit)	2,657	(92)
Net change in interest receivable	202	825
Net change in other assets	(233)	865
Net change in interest payable	(77)	(164)
Net change in other liabilities	1,018	1,263
Net cash provided by operating activities	<u>14,074</u>	<u>12,580</u>
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sales of securities available for sale	4,209	2,099
Proceeds from maturities and calls of securities available for sale	52,328	56,405
Proceeds from maturities and calls of securities held to maturity	-	961
Purchases of securities available for sale	(50,641)	(84,725)
Net change in restricted stock	735	(505)
Net decrease in loans	27,475	30,018
Proceeds from sale of premises and equipment	572	(114)
Purchases of premises and equipment	(594)	(549)
Proceeds from sales of foreclosed real estate	4,720	1,896
Purchases of foreclosed real estate	-	(51)
Cash paid in bank acquisition	-	(12)
Cash acquired in bank acquisition	-	34,783
Net cash provided by investing activities	<u>38,804</u>	<u>40,206</u>
<b>Cash Flows from Financing Activities:</b>		
Net change in demand, money market, and savings deposits	(14,251)	31,502
Net change in time deposits	8,335	(27,212)
Net change in customer repurchase agreements	186	(3,326)
Net change in other short-term borrowings	(3,000)	(6,110)
Net change in long-term borrowings	(112)	(8,114)
Common stock dividends paid	(5,407)	(4,626)
Preferred stock dividends paid	-	(51)
Proceeds from exercise of stock options	118	173
Net cash used in financing activities	<u>(14,131)</u>	<u>(17,764)</u>
Net Increase in Cash and Cash Equivalents	38,747	35,022
Cash and Cash Equivalents at Beginning of Period	<u>28,893</u>	<u>18,514</u>
Cash and Cash Equivalents at End of Period	<u>\$ 67,640</u>	<u>\$ 53,536</u>

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



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

***Note 1 – Basis of Presentation***

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

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

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

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

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

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the AMNB Trust and the MidCarolina Trusts, as detailed in Note 9.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the Company’s financial position as of September 30, 2012; the consolidated statements of income for the three and nine months ended September 30, 2012 and 2011; the consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011; the consolidated statements of changes in shareholders’ equity for the nine months ended September 30, 2012 and 2011; and the consolidated statements of cash flows for the nine months ended September 30, 2012 and 2011. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may occur for the year ending December 31, 2012. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company’s Form 10-K for the year ended December 31, 2011.

***Note 2 – Merger with MidCarolina***

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

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

The Company issued 1,626,157 shares of additional common stock in connection with the MidCarolina merger. This represents 20.7% of the outstanding shares of the Company as of September 30, 2012.

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

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

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

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

(dollars in thousands)	
<b>Consideration Paid:</b>	
Common shares issued (1,626,157)	\$ 29,905
Cash paid to Shareholders	12
Fair Value of Options	132
Preferred shares issued (5,000)	5,000
Value of consideration	<u>35,049</u>
<b>Assets acquired:</b>	
Cash and cash equivalents	34,783
Investment securities	51,442
Loans held for sale	113
Loans, net of unearned income	328,123
Premises and equipment, net	5,708
Deferred income taxes	15,310
Core deposit intangible	6,556
Other real estate owned	3,538
Other assets	13,535
Total assets	<u>459,108</u>
<b>Liabilities assumed:</b>	
Deposits	420,248
FHLB advances	9,858
Other borrowings	6,546
Other liabilities	3,982
Total Liabilities	<u>440,634</u>
<b>Net assets acquired</b>	<u>18,474</u>
<b>Goodwill resulting from merger with MidCarolina</b>	<u><b>\$ 16,575</b></u>

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

Goodwill at December 31, 2011	\$16,431
Effect of adjustments to:	
Other liabilities	144
Goodwill at June 30, 2012	<u>\$16,575</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

Direct costs related to the acquisition were expensed as incurred. During the entire year of 2011, the Company incurred \$1,600,000 in merger and acquisition expenses. During 2012, the Company incurred \$19,000 in merger related expense.

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

	<u>Nine Months Ended</u>	
	Pro Forma	
	September 30,	
	2011	
(dollars in thousands)		
Net interest income	\$	39,772
Provision for loan loss		(3,598)
Non-interest income		7,712
Non-interest expense		(30,070)
Income taxes		(4,182)
Net income	\$	<u>9,634</u>

**Note 3 – Securities**

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

(in thousands)	<b>September 30, 2012</b>			
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Estimated Fair Value</b>
Securities available for sale:				
Federal agencies and GSEs	\$ 29,739	\$ 351	\$ -	\$ 30,090
Mortgage-backed and CMOs	88,937	2,240	129	91,048
State and municipal	185,534	13,805	5	199,334
Corporate	7,353	169	-	7,522
Total securities available for sale	<u>\$ 311,563</u>	<u>\$ 16,565</u>	<u>\$ 134</u>	<u>\$ 327,994</u>

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

**Temporarily Impaired Securities**

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2012. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

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

(in thousands)	<b>Total</b>		<b>Less than 12 Months</b>		<b>12 Months or More</b>	
	<b>Estimated Fair Value</b>	<b>Unrealized Loss</b>	<b>Estimated Fair Value</b>	<b>Unrealized Loss</b>	<b>Estimated Fair Value</b>	<b>Unrealized Loss</b>
Mortgage-backed	\$ 6,738	\$ 56	\$ 2,953	\$ 8	\$ 3,785	\$ 48
CMOs	2,568	73	-	-	2,568	73
State and municipal	2,597	5	2,597	5	-	-
Total	<u>\$ 11,903</u>	<u>\$ 134</u>	<u>\$ 5,550</u>	<u>\$ 13</u>	<u>\$ 6,353</u>	<u>\$ 121</u>

*GSE residential mortgage-backed securities:* The unrealized losses on the Company's investment in five GSE mortgage-backed securities were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2012.

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

*State and municipal securities:* The unrealized losses on six investments in state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2012.

The Company's investment in FHLB stock totaled \$2,417,000 at September 30, 2012. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at September 30, 2012 and no impairment has been recognized. FHLB stock is shown in restricted stock on the balance sheet and is not a part of the available for sale securities portfolio.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2011.

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

#### *Other-Than-Temporary-Impaired Securities*

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

#### *Note 4 - Loans*

##### Segments

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

(in thousands)	September 30, 2012	December 31, 2011
Commercial	\$ 126,339	\$ 134,166
Commercial real estate:		
Construction and land development	50,688	54,433
Commercial real estate	356,692	351,961
Residential real estate:		
Residential	162,404	179,812
Home equity	95,008	96,195
Consumer	6,687	8,191
Total loans	\$ 797,818	\$ 824,758

### Acquired Loans

Interest income, including accretion, on loans acquired from MidCarolina for the three months ended September 30, 2012 was approximately \$4.9 million and \$17.8 million for the nine months ended September 30, 2012. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at September 30, 2012 and December 31, 2011 are as follows:

(in thousands)	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Outstanding principal balance	\$ 248,089	\$ 321,002
Carrying amount	229,792	293,569

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

(in thousands)	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Outstanding principal balance	\$ 30,457	\$ 45,760
Carrying amount	22,904	34,027

The following table presents changes in the accretable discount on acquired impaired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), for the nine months ended September 30, 2012. The accretion reflected below includes \$1,899,000 related to loan payoffs.

(in thousands)	<b>Accretable Discount</b>
Balance at December 31, 2011	\$ 1,056
Accretion	(71)
Reclassification from nonaccretable difference	2,130
Balance at September 30, 2012	<u>\$ 3,115</u>

Past Due Loans

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

(in thousands)	<u>30- 59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days + Past Due and Still Accruing</u>	<u>Non- Accrual Loans</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>
Commercial	\$ 268	\$ -	\$ -	\$ 1,159	\$ 1,427	\$ 124,912	\$ 126,339
Commercial real estate:							
Construction and land development	9	201	-	1,107	1,317	49,371	50,688
Commercial real estate	134	326	-	3,035	3,495	353,197	356,692
Residential:							
Residential	611	147	-	1,948	2,706	159,698	162,404
Home equity	314	-	-	566	880	94,128	95,008
Consumer	47	5	-	-	52	6,635	6,687
<b>Total</b>	<u>\$ 1,383</u>	<u>\$ 679</u>	<u>\$ -</u>	<u>\$ 7,815</u>	<u>\$ 9,877</u>	<u>\$ 787,941</u>	<u>\$ 797,818</u>

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

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



## Impaired Loans

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

(in thousands)	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<b>With no related allowance recorded:</b>					
Commercial	\$ 150	\$ 382	\$ -	\$ 185	\$ -
Commercial real estate:					
Construction and land development	1,283	1,315	-	1,543	-
Commercial real estate	212	212	-	554	7
Residential:					
Residential	274	541	-	1,057	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 1,919</u>	<u>\$ 2,450</u>	<u>\$ -</u>	<u>\$ 3,339</u>	<u>\$ 7</u>
<b>With an related allowance recorded:</b>					
Commercial	249	249	246	112	7
Commercial real estate:					
Construction and land development	-	-	-	-	-
Commercial real estate	232	232	68	104	11
Residential:					
Residential	-	-	-	-	-
Home equity	-	-	-	-	-
Consumer	21	21	21	7	-
	<u>\$ 502</u>	<u>\$ 502</u>	<u>\$ 335</u>	<u>\$ 223</u>	<u>\$ 18</u>
<b>Total:</b>					
Commercial	\$ 399	\$ 631	\$ 246	\$ 297	\$ 7
Commercial real estate:					
Construction and land development	1,283	1,315	-	1,543	-
Commercial real estate	444	444	68	658	18
Residential:					
Residential	274	541	-	1,057	-
Home equity	-	-	-	-	-
Consumer	21	21	21	7	-
	<u>\$ 2,421</u>	<u>\$ 2,952</u>	<u>\$ 335</u>	<u>\$ 3,562</u>	<u>\$ 25</u>

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

(in thousands)	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<b>With no related allowance recorded:</b>					
Commercial	\$ -	\$ -	\$ -	\$ 48	\$ -
Commercial real estate:					
Construction and land development	364	391	-	292	-
Commercial real estate	279	279	-	207	17
Residential:					
Residential	1,185	1,276	-	376	2
Home equity	89	89	-	50	3
Consumer	49	56	-	17	-
	<u>\$ 1,966</u>	<u>\$ 2,091</u>	<u>\$ -</u>	<u>\$ 990</u>	<u>\$ 22</u>
<b>With an related allowance recorded:</b>					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate:					
Construction and land development	363	363	49	139	-
Commercial real estate	888	888	80	75	-
Residential:					
Residential	21	21	1	7	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
	<u>\$ 1,272</u>	<u>\$ 1,272</u>	<u>\$ 130</u>	<u>\$ 221</u>	<u>\$ -</u>
<b>Total:</b>					
Commercial	\$ -	\$ -	\$ -	\$ 48	\$ -
Commercial real estate:					
Construction and land development	727	754	49	431	-
Commercial real estate	1,167	1,167	80	282	17
Residential:					
Residential	1,206	1,297	1	383	2
Home equity	89	89	-	50	3
Consumer	49	56	-	17	-
	<u>\$ 3,238</u>	<u>\$ 3,363</u>	<u>\$ 130</u>	<u>\$ 1,211</u>	<u>\$ 22</u>

The following tables show the details of loans modified as troubled debt restructurings ("TDRs") included in the impaired loan balances for the three and nine month periods ended September 30, 2012.

(dollars in thousands)	Loans Modified as a TDR for the Three Months Ended September 30, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial	-	\$ -	\$ -
Commercial real estate:			
Construction and land development	-	-	-
Commercial real estate	1	229	229
Consumer	1	22	21
Total	<u>2</u>	<u>\$ 251</u>	<u>\$ 250</u>

Loans Modified as a TDR for the  
Nine Months Ended September 30, 2012

(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial	1	\$ 11	\$ 11
Commercial real estate:			
Construction and land development	7	2,188	2,053
Commercial real estate	2	233	233
Consumer	1	22	21
Total	11	\$ 2,454	\$ 2,318

None of the loans modified as a TDR within the previous twelve months have subsequently defaulted during the three and nine month periods ending September 30, 2012.

Risk Grades

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

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

	<u>Commercial</u>	<u>Commercial Real Estate Construction</u>	<u>Commercial Real Estate Other</u>	<u>Residential</u>	<u>Home Equity</u>
Pass	\$ 123,988	\$ 41,192	\$ 339,611	\$ 149,304	\$ 92,722
Special Mention	1,084	2,417	10,428	8,815	1,063
Substandard	1,267	7,079	6,653	4,285	1,223
Doubtful	-	-	-	-	-
Total	<u>\$ 126,339</u>	<u>\$ 50,688</u>	<u>\$ 356,692</u>	<u>\$ 162,404</u>	<u>\$ 95,008</u>

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

	<u>Consumer</u>
Performing	\$ 6,581
Nonperforming	106
Total	<u>\$ 6,687</u>

Loans classified as substandard have decreased over the past nine month from approximately \$39 million at year end to approximately \$20 million at September 30, 2012. Management has been actively pursuing resolution of problem credits. The largest component of this improvement was the successful resolution of several large loans acquired with deteriorated credit quality during the first two quarters of the year, which totaled \$2 million.

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

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

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

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

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

The following table shows the Company's commercial loan portfolio broken down by internal risk grading as of December 31, 2011.

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

	<u>Commercial</u>	<u>Commercial Real Estate Construction</u>	<u>Commercial Real Estate Other</u>	<u>Residential</u>	<u>Home Equity</u>
Pass	\$ 130,603	\$ 35,265	\$ 321,370	\$ 161,158	\$ 93,193
Special Mention	1,349	3,401	19,072	10,166	1,606
Substandard	2,214	15,767	11,519	8,488	1,396
Doubtful	-	-	-	-	-
Total	<u>\$ 134,166</u>	<u>\$ 54,433</u>	<u>\$ 351,961</u>	<u>\$ 179,812</u>	<u>\$ 96,195</u>

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

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

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

Changes in the allowance for loan losses and the reserve for unfunded lending commitments as of the indicated dates and periods are presented below:

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

(in thousands)	<b>Nine Months Ended September 30, 2012</b>	<b>Year Ended December 31, 2011</b>	<b>Nine Months Ended September 30, 2011</b>
<b>Allowance for Loan Losses</b>			
Balance, beginning of period	\$ 10,529	\$ 8,420	\$ 8,420
Provision for loan losses	1,799	3,170	1,198
Charge-offs	(1,682)	(1,863)	(957)
Recoveries	1,352	802	425
Balance, end of period	<u>\$ 11,998</u>	<u>\$ 10,529</u>	<u>\$ 9,086</u>
<b>Reserve for Unfunded Lending Commitments</b>			
Balance, beginning of period	\$ 200	\$ 218	\$ 218
Provision for (recovery of) loan losses	4	(18)	(15)
Charge-offs	-	-	-
Balance, end of period	<u>\$ 204</u>	<u>\$ 200</u>	<u>\$ 203</u>

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

(in thousands)	<b>Commercial</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer</b>	<b>Total</b>
<b>Allowance for Loan Losses</b>					
Balance as of December 31, 2011	\$ 1,236	\$ 5,719	\$ 3,412	\$ 162	\$ 10,529
Charge-offs	(560)	(472)	(604)	(46)	(1,682)
Recoveries	681	451	154	66	1,352
Provision	249	973	548	29	1,799
Balance as of September 30, 2012	<u>\$ 1,606</u>	<u>\$ 6,671</u>	<u>\$ 3,510</u>	<u>\$ 211</u>	<u>\$ 11,998</u>
<b>Balances as of September 30, 2012</b>					
<b>Allowance for Loan Losses</b>					
Individually evaluated for impairment	\$ 246	\$ 68	\$ -	\$ 21	\$ 335
Collectively evaluated for impairment	1,360	6,603	3,510	190	11,663
Total	<u>\$ 1,606</u>	<u>\$ 6,671</u>	<u>\$ 3,510</u>	<u>\$ 211</u>	<u>\$ 11,998</u>
<b>Loans</b>					
Individually evaluated for impairment	\$ 399	\$ 1,727	\$ 274	\$ 21	\$ 2,421
Collectively evaluated for impairment	124,542	391,555	249,730	6,666	772,493
Loans acquired with deteriorated credit quality	1,398	14,098	7,408	-	22,904
Total	<u>\$ 126,339</u>	<u>\$ 407,380</u>	<u>\$ 257,412</u>	<u>\$ 6,687</u>	<u>\$ 797,818</u>

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

(in thousands)	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Total</u>
<b>Allowance for Loan Losses</b>					
Balance as of December 31, 2010	\$ 751	\$ 4,631	\$ 2,921	\$ 117	\$ 8,420
Charge-offs	(163)	(702)	(871)	(127)	(1,863)
Recoveries	373	306	50	73	802
Provision	275	1,484	1,312	99	3,170
Balance as of December 31, 2011	<u>\$ 1,236</u>	<u>\$ 5,719</u>	<u>\$ 3,412</u>	<u>\$ 162</u>	<u>\$ 10,529</u>
Balance as of December 31, 2011:					
<b>Allowance for Loan Losses</b>					
Individually evaluated for impairment	\$ -	\$ 129	\$ 1	\$ -	\$ 130
Collectively evaluated for impairment	1,236	5,590	3,411	162	10,399
Total	<u>\$ 1,236</u>	<u>\$ 5,719</u>	<u>\$ 3,412</u>	<u>\$ 162</u>	<u>\$ 10,529</u>
<b>Loans</b>					
Individually evaluated for impairment	\$ -	\$ 1,894	\$ 1,295	\$ 49	\$ 3,238
Collectively evaluated for impairment	131,755	381,175	266,421	8,142	787,493
Loans acquired with deteriorated credit quality	2,411	23,325	8,291	-	34,027
Total	<u>\$ 134,166</u>	<u>\$ 406,394</u>	<u>\$ 276,007</u>	<u>\$ 8,191</u>	<u>\$ 824,758</u>

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analyses of smaller balance, homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national and local economic trends and conditions; and concentrations of credit. Since the July 2011 merger with MidCarolina, the Bank must also consider the velocity of accretion of the fair value, credit mark in relation to the amortization of the related loan balances. A large percentage of the Bank's North Carolina loan portfolio is commercial real estate, with relatively short maturities, with balloon payments, and relatively long amortization periods. This structure results in more rapid accretion of the mark than amortization of loan principal. While this is not a proximate cause in and of itself for additional provision, it does result in an increased volume of loans that must be evaluated for potential loss as they are renewed, on current market terms, and become part of the regular portfolio.

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

Goodwill is subject to at least an annual assessment for impairment by applying a fair value test. An annual fair value-based test was performed in 2012 that determined the market value of the Company's shares exceeded the consolidated carrying value, including goodwill; therefore, there has been no impairment recognized in the value of goodwill.

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

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

	<u>Goodwill</u>	<u>Intangibles</u>
Balance as of December 31, 2011	\$ 38,899	\$ 6,595
Additions	144	-
Amortization	-	(1,514)
Impairment	-	-
Balance as of September 30, 2012	<u>\$ 39,043</u>	<u>\$ 5,081</u>

**Note 7 – Short-term Borrowings**

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies or GSEs. They mature daily. The interest rates may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following as of September 30, 2012 and December 31, 2011 (in thousands):

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Customer repurchase agreements	\$ 45,761	\$ 45,575
FHLB overnight borrowings	-	3,000
	<u>\$ 45,761</u>	<u>\$ 48,575</u>

**Note 8 – Long-term Borrowings**

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of September 30, 2012, \$284,132,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of September 30, 2012 and December 31, 2011 (dollars in thousands):

<b>September 30, 2012</b>			<b>December 31, 2011</b>		
<b>Due by</b>	<b>Advance Amount</b>	<b>Weighted Average Rate</b>	<b>Due by</b>	<b>Advance Amount</b>	<b>Weighted Average Rate</b>
April 2014	\$ 225	3.78%	April 2014	\$ 337	3.78%
November 2017	9,886	2.98	November 2017	9,869	2.98
	<u>\$ 10,111</u>	<u>3.00%</u>		<u>\$ 10,206</u>	<u>3.01%</u>

The advance due in November 2017 is net of a valuation allowance of \$114,000. The original valuation allowance recorded on July 1, 2011, was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the States of Virginia and North Carolina. At September 30, 2012, the Bank's public deposits totaled \$119,101,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At September 30, 2012, the Company had \$72,000,000 in letters of credit with the FHLB outstanding, as well as \$76,732,000 in government and agency securities to provide collateral for such deposits.

**Note 9 – Trust Preferred Capital Notes**

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

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

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

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

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

Issuing Entity	Date Issued	Interest Rate	Maturity Date	(Amounts in thousands) Principal Amount	
				September 30, 2012	December 31, 2011
AMNB Trust I	04-07-06	Libor plus 1.35%	06-30-36	\$ 20,619	\$ 20,619
MidCarolina I	10-29-02	Libor plus 3.45%	11-07-32	4,028	3,986
MidCarolina II	12-03-03	Libor plus 2.95%	10-07-33	2,645	2,607
				<u>\$ 27,292</u>	<u>\$ 27,212</u>

The principal amounts reflected for the MidCarolina Trusts are net of valuation allowances of \$1,127,000 and \$964,000 respectively. The original valuation allowances of \$1,197,000 and \$1,021,000 were recorded as a result of the merger with MidCarolina on July 1, 2011, and are being amortized into interest expense over the remaining lives of the respective borrowings.



**Note 10 – Stock Based Compensation**

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

*Stock Options*

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

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

	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value (\$000)</u>
Outstanding at December 31, 2011	268,639	\$ 23.94		
Granted	-	-		
Exercised	(6,845)	17.19		
Forfeited	-	-		
Outstanding at September 30, 2012	<u>261,794</u>	\$ 24.12	3.79 years	\$ 348
Exercisable at September 30, 2012	<u>261,794</u>	\$ 24.12	3.79 years	\$ 348

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. As of September 30, 2012, there was no unrecognized compensation expenses related to nonvested stock option grants.

*Restricted Stock*

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

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

<u>Restricted Stock</u>	<u>Shares</u>	<u>Weighted Average Grant Date Value</u>
Nonvested at January 1, 2012	38,349	\$ 20.53
Granted	15,290	19.30
Vested	14,312	21.20
Forfeited	-	-
Nonvested at September 30, 2012	<u>39,327</u>	\$ 20.17

As of September 30, 2012 and December 31, 2011, there was \$438,000 and \$206,000 in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.35 years. The share based compensation expense for nonvested restricted stock was \$260,000 and \$205,000 during the first nine months of 2012 and 2011, respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. For 2012, the regular quarterly board retainer can be received in the form of either (i) \$3,000 in cash or (ii) shares of immediately vested, but restricted stock, with a market value of \$4,688. Monthly meeting fees can also be received as \$600 per meeting in cash or \$750 in immediately vested, but restricted stock. For 2012, 12 of 13 directors elected to receive stock in lieu of cash for their monthly retainer board meeting fees. Only outside directors receive board fees. The Company issued 14,217 and 8,925 shares and recognized share based compensation expense of \$308,000 and \$170,000 during the first nine months of 2012 and 2011, respectively.

**Note 11 – Earnings Per Share**

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

	<b>Three Months Ended</b>			
	<b>September 30,</b>			
	<b>2012</b>		<b>2011</b>	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,838,314	\$ 0.46	7,800,614	\$ 0.52
Effect of dilutive securities - stock options	17,223	-	6,054	-
Diluted	<u>7,855,537</u>	<u>\$ 0.46</u>	<u>7,806,668</u>	<u>\$ 0.52</u>

	<b>Nine Months Ended</b>			
	<b>September 30,</b>			
	<b>2012</b>		<b>2011</b>	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,830,928	\$ 1.54	6,705,607	\$ 1.02
Effect of dilutive securities - stock options	15,731	-	7,353	-
Diluted	<u>7,846,659</u>	<u>\$ 1.54</u>	<u>6,712,960</u>	<u>\$ 1.02</u>

Stock options on common stock which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2012 and 2011, because their effects were antidilutive, averaged 163,559 and 114,081, respectively.

**Note 12 – Employee Benefit Plans**

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

Components of Net Periodic Benefit Cost (in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Service cost	\$ -	\$ 27	\$ -	\$ 81
Interest cost	97	101	291	303
Expected return on plan assets	(135)	(131)	(405)	(393)
Recognized net actuarial loss	83	40	249	120
Net periodic benefit cost	<u>\$ 45</u>	<u>\$ 37</u>	<u>\$ 135</u>	<u>\$ 111</u>

The plan was frozen in 2009.

**Note 13 – Segment and Related Information**

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

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

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

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

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

(in thousands)	<b>Three Months Ended September 30, 2012</b>				
	<b>Community Banking</b>	<b>Trust and Investment Services</b>	<b>Other</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Interest income	\$ 13,546	\$ -	\$ 1	\$ (1)	\$ 13,546
Interest expense	1,843	-	204	(1)	2,046
Noninterest income	1,640	1,034	16	-	2,690
Income before income taxes	4,628	637	(288)	-	4,977
Net income	3,364	465	(190)	-	3,639
Depreciation and amortization	866	5	-	-	871
Total assets	1,304,795	-	912	-	1,305,707
Capital expenditures	21	-	-	-	21

	<b>Three Months Ended September 30, 2011</b>				
	<b>Community Banking</b>	<b>Trust and Investment Services</b>	<b>Other</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Interest income	\$ 14,779	\$ -	\$ 16	\$ (16)	\$ 14,779
Interest expense	2,288	-	164	(16)	2,436
Noninterest income	1,657	1,036	5	-	2,698
Income before income taxes	5,720	663	(431)	-	5,952
Net income	4,036	438	(345)	-	4,129
Depreciation and amortization	716	5	-	-	721
Total assets	1,304,236	-	903	-	1,305,139
Capital expenditures	300	-	-	-	300

	<b>Nine Months Ended September 30, 2012</b>				
	<b>Community Banking</b>	<b>Trust and Investment Services</b>	<b>Other</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Interest income	\$ 43,774	\$ -	\$ 6	\$ (6)	\$ 43,774
Interest expense	5,675	-	617	(6)	6,286
Noninterest income	5,601	3,096	27	-	8,724
Income before income taxes	15,815	1,845	(887)	-	16,773
Net income	11,348	1,330	(590)	-	12,088
Depreciation and amortization	2,814	15	-	-	2,829
Total assets	1,304,795	-	912	-	1,305,707
Capital expenditures	594	-	-	-	594

	<b>Nine Months Ended September 30, 2011</b>				
	<b>Community Banking</b>	<b>Trust and Investment Services</b>	<b>Other</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Interest income	\$ 32,010	\$ -	\$ 48	\$ (48)	\$ 32,010
Interest expense	5,707	-	804	(48)	6,463
Noninterest income	3,714	2,919	24	-	6,657
Operating income before income taxes	9,956	1,841	(2,162)	-	9,635
Net income	7,506	1,215	(1,802)	-	6,919
Depreciation and amortization	1,493	15	-	-	1,508
Total assets	1,304,236	-	903	-	1,305,139
Capital expenditures	549	-	-	-	549

## *Note 14 – Fair Value of Financial Instruments*

### Determination of Fair Value

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

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

### Fair Value Hierarchy

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

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

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

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

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis during the period (in thousands):

Description	Fair Value Measurements at September 30, 2012 Using			
	Balance as of September 30, 2012	Quoted Prices in Active Markets for Identical Assets		
		Significant Other Observable Inputs	Significant Unobservable Inputs	
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$ 30,090	\$ -	\$ 30,090	\$ -
Mortgage-backed and CMOs	91,048	-	91,048	-
State and municipal	199,334	-	199,334	-
Corporate	7,522	-	7,178	344
Total	\$ 327,994	\$ -	\$ 327,650	\$ 344

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

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)						
	Total Realized / Unrealized Gains (Losses) Included in			Purchases, Sales, Issuances and Settlements, Net	Transfer In (Out) of Level 3	Balances as of September 30, 2012
	Balances as of January 1, 2012	Net Income	Other Comprehensive Income			
Securities available for sale:						
Corporate	\$ 324	\$ 20	\$ -	\$ -	\$ -	\$ 344
Total assets	\$ 324	\$ 20	\$ -	\$ -	\$ -	\$ 344

Certain assets are measured at fair value on a nonrecurring basis in accordance with U.S. GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

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

**Loans held for sale:** Loans held for sale are carried at estimated fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the period ended September 30, 2012. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.



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

**Other real estate owned ("OREO"):** Property acquired in satisfaction of loans is carried at the lower of cost or market value. The value of real estate is determined utilizing an income or market valuation approach less cost to sell based on an appraisal conducted by an independent, licensed appraiser outside of the company using observable market data (Level 2). However, if the real estate is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. OREO is measured at fair value on a nonrecurring basis. Any initial fair value adjustment is charged against the allowance for loan loss. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest expense on the Consolidated Statements of Income.

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

Description	Fair Value Measurements at September 30, 2012 Using			
	Balance as of September 30, 2012	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$ 8,118	\$ -	\$ 8,118	\$ -
Impaired loans, net of valuation allowance	167	-	167	-
Other real estate owned	6,259	-	6,259	-

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



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

	<b>Fair Value Measurements at September 30, 2012 using</b>				
	<b>Carrying Value</b>	<b>Quoted Prices in Active Markets for Identical Assets</b>	<b>Significant Other Observable Inputs</b>	<b>Significant Unobservable Inputs</b>	<b>Fair Value</b>
		<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Balance</b>
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 67,640	\$ 67,640	\$ -	\$ -	\$ 67,640
Securities available for sale	327,994	-	327,650	344	327,994
Loans held for sale	8,118	-	8,118	-	8,118
Loans, net of allowance	785,820	-	779,725	-	779,725
Bank owned life insurance	13,380	-	13,380	-	13,380
Accrued interest receivable	4,889	-	4,889	-	4,889
<b>Financial Liabilities:</b>					
Deposits	\$ 1,052,427	\$ -	\$ 1,037,164	\$ -	\$ 1,037,164
Repurchase agreements	45,761	-	45,761	-	45,761
Other borrowings	10,111	-	11,064	-	11,064
Trust preferred capital notes	27,292	-	23,427	-	23,427
Accrued interest payable	780	-	780	-	780

The Company has one Level 3 security, a trust preferred security issued by a community bank. It is a Level 3 security under the three-tier fair value hierarchy because of an absence of observable inputs for these and similar securities in the debt markets. The Company acquired this security in connection with merger with MidCarolina and initially obtained an independent third party appraisal of the fair value at July 1, 2011. Because of the lack of observable inputs, the valuation was completed using a discounted cash flow computation, adjusted for an estimated default rate determined by reviewing industry statistics. The merger date initial fair value estimate of the security was 67.28% of its \$500,000 par, or \$336,000. Approximately \$147,000 of this impairment was attributed to factors other than credit, and \$17,000 was attributable to credit factors. The security has performed according to contractual terms since the merger so the Company has not considered it necessary to adjust the impairment estimates.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*Off-balance sheet instruments.* The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2012 and December 31, 2011, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

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

*Note 15 – Supplemental Cash Flow Information*

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$ 25,740	\$ 23,450
Interest-bearing deposits in other banks	41,900	30,086
	<u>\$ 67,640</u>	<u>\$ 53,536</u>
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	\$ 5,924	\$ 6,311
Income taxes	108	1,754
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	5,735	685
Unrealized gain on securities available for sale	2,844	8,509
Transactions related to acquisitions:		
Assets acquired:		
Investment securities	-	51,442
Loans held for sale	-	113
Loans, net of unearned income	-	327,112
Premises and equipment, net	-	6,861
Deferred income taxes	-	15,626
Core deposit intangible	-	6,556
Other real estate owned	-	3,538
Other assets	-	14,135
Liabilities assumed:		
Demand, MMDA, & savings deposits	-	281,311
Time deposits	-	138,937
FHLB advances	-	9,858
Other borrowings	-	6,546
Other liabilities	-	3,838
Issuance of preferred stock	-	5,000
Issuance of common stock	-	29,905

### ***Note 16 – Recent Accounting Pronouncements***

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

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

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

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

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

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

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

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

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

### **Forward-Looking Statements**

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

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

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

### **Reclassification**

In certain circumstances, reclassifications have been made to prior period information to conform to the 2012 presentation.

## **CRITICAL ACCOUNTING POLICIES**

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses, (2) acquired loans with specific credit-related deterioration and (3) goodwill impairment.

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

### Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses inherent in the loan portfolio at the balance sheet date. The allowance is based on two basic principles of accounting: Financial Accounting Standards Board (“FASB”) Topic 450-25 *Contingencies - Recognition* which requires that losses be accrued when they are probable of occurring and estimable and FASB Topic 310-10 *Receivables – Overall – Subsequent Measurement* which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows, or values observable in the secondary market, and the loan balance.

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

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

### Acquired Loans with Specific Credit-Related Deterioration

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

### Goodwill Impairment

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

### Non-GAAP Presentations

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

### Internet Access to Corporate Documents

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

## ACQUISITION OF MIDCAROLINA FINANCIAL CORPORATION

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

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

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

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

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

To date, the acquisition has been accretive to earnings.



## RESULTS OF OPERATIONS

### Earnings Performance

#### Three months ended September 30, 2012 and 2011

For the quarter ended September 30, 2012, the Company reported net income of \$3,639,000 compared to \$4,129,000 for the comparable quarter in 2011. The \$490,000 or 11.9% decrease in earnings was primarily due to declines in yields on earning assets.

#### SUMMARY INCOME STATEMENT (Dollars in thousands)

For the three months ended September 30,	2012	2011	\$ Change	% Change
Interest income	\$ 13,546	\$ 14,779	\$ (1,233)	-8.3%
Interest expense	(2,046)	(2,436)	390	-16.0%
Net interest income	11,500	12,343	(843)	-6.8%
Provision for loan losses	(333)	(525)	192	-36.6%
Noninterest income	2,690	2,698	(8)	-0.3%
Noninterest expense	(8,880)	(8,564)	(316)	3.7%
Income tax expense	(1,338)	(1,823)	485	-26.6%
Net income	<u>\$ 3,639</u>	<u>\$ 4,129</u>	<u>\$ (490)</u>	-11.9%

#### Nine months ended September 30, 2012 and 2011

For the nine month period ended September 30, 2012, the Company reported net income of \$12,088,000 compared to \$6,919,000 for the comparable period in 2011. The \$5,169,000 or 74.7% increase in earnings was primarily due to the positive impact of the July 2011 merger with MidCarolina.

#### SUMMARY INCOME STATEMENT (Dollars in thousands)

For the nine months ended September 30,	2012	2011	\$ Change	% Change
Interest income	\$ 43,774	\$ 32,010	\$ 11,764	36.8%
Interest expense	(6,286)	(6,463)	177	-2.7%
Net interest income	37,488	25,547	11,941	46.7%
Provision for loan losses	(1,799)	(1,198)	(601)	50.2%
Noninterest income	8,724	6,657	2,067	31.1%
Noninterest expense	(27,640)	(21,371)	(6,269)	29.3%
Income tax expense	(4,685)	(2,716)	(1,969)	72.5%
Net income	<u>\$ 12,088</u>	<u>\$ 6,919</u>	<u>\$ 5,169</u>	74.7%

## Net Interest Income

Net interest income is the difference between interest income on earning assets, primarily loans and securities, and interest expense on interest bearing liabilities, primarily deposits and other funding sources. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income. The following discussion of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets, such as certain state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent basis. Net interest income divided by average earning assets is referred to as the net interest margin. The net interest spread represents the difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities.

### Three months ended September 30, 2012 and 2011

Net interest income on a taxable equivalent basis decreased \$834,000 or 6.5%, for the third quarter of 2012 compared to the same quarter of 2011. This was almost entirely due to declines in yields on earning assets, which was only partially mitigated by reductions in the cost of interest bearing liabilities.

For the third quarter of 2012, the Company's yield on interest-earning assets was 4.84% compared to 5.23% for the third quarter of 2011. The cost of interest-bearing liabilities was 0.88% compared to 0.99%. The interest rate spread was 3.96% compared to 4.24%. The net interest margin, on a fully taxable equivalent basis, was 4.14% compared to 4.41%, for a reduction of 27 basis points (0.27%).

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

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

	Average Balance		Interest Income/Expense		Yield/Rate	
	2012	2011	2012	2011	2012	2011
<b>Loans:</b>						
Commercial	\$ 126,701	\$ 136,204	\$ 1,598	\$ 1,603	5.00%	4.67%
Real estate	676,905	685,628	9,743	10,778	5.76	6.29
Consumer	6,844	8,529	119	163	6.90	7.58
Total loans	<u>810,450</u>	<u>830,361</u>	<u>11,460</u>	<u>12,544</u>	<u>5.65</u>	<u>6.04</u>
<b>Securities:</b>						
Federal agencies	36,181	32,448	118	186	1.30	2.29
Mortgage-backed & CMOs	92,708	87,785	472	615	2.04	2.80
State and municipal	180,820	168,134	1,933	1,896	4.28	4.51
Other	13,846	7,728	121	78	3.50	4.04
Total securities	<u>323,555</u>	<u>296,095</u>	<u>2,644</u>	<u>2,775</u>	<u>3.27</u>	<u>3.75</u>
Deposits in other banks	<u>32,567</u>	<u>45,526</u>	<u>19</u>	<u>28</u>	<u>0.23</u>	<u>0.24</u>
Total interest-earning assets	<u>1,166,572</u>	<u>1,171,982</u>	<u>14,123</u>	<u>15,347</u>	<u>4.84</u>	<u>5.23</u>
Non-earning assets	<u>131,126</u>	<u>134,814</u>				
Total assets	<u>\$ 1,297,698</u>	<u>\$ 1,306,796</u>				
<b>Deposits:</b>						
Demand	\$ 144,284	\$ 171,744	44	132	0.12	0.30
Money market	168,212	208,962	126	232	0.30	0.44
Savings	78,808	72,088	29	26	0.15	0.14
Time	448,598	444,079	1,526	1,689	1.35	1.51
Total deposits	<u>839,902</u>	<u>896,873</u>	<u>1,725</u>	<u>2,079</u>	<u>0.81</u>	<u>0.92</u>
Customer repurchase agreements	46,297	45,356	33	82	0.28	0.72
Other short-term borrowings	-	2	-	-	-	0.75
Long-term borrowings	<u>37,413</u>	<u>37,439</u>	<u>288</u>	<u>275</u>	<u>3.08</u>	<u>2.94</u>
Total interest-bearing liabilities	<u>923,612</u>	<u>979,670</u>	<u>2,046</u>	<u>2,436</u>	<u>0.88</u>	<u>0.99</u>
Noninterest bearing demand deposits	204,532	170,618				
Other liabilities	9,686	7,475				
Shareholders' equity	<u>159,868</u>	<u>149,033</u>				
Total liabilities and shareholders' equity	<u>\$ 1,297,698</u>	<u>\$ 1,306,796</u>				
Interest rate spread					<u>3.96%</u>	<u>4.24%</u>
Net interest margin					<u>4.14%</u>	<u>4.41%</u>
Net interest income (taxable equivalent basis)			12,077	12,911		
Less: Taxable equivalent adjustment			<u>577</u>	<u>568</u>		
Net interest income			<u>\$ 11,500</u>	<u>\$ 12,343</u>		

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

	Three Months Ended September 30 2012 vs. 2011		
	Interest Increase (Decrease)	Change Attributable to	
		Rate	Volume
Interest income			
Loans:			
Commercial	\$ (5)	\$ 111	\$ (116)
Real Estate	(1,035)	(899)	(136)
Consumer	(44)	(14)	(30)
Total loans	<u>(1,084)</u>	<u>(802)</u>	<u>(282)</u>
Securities:			
Federal agencies	(68)	(87)	19
Mortgage-backed	(143)	(176)	33
State and municipal	37	(102)	139
Other securities	43	(12)	55
Total securities	<u>(131)</u>	<u>(377)</u>	<u>246</u>
Deposits in other banks	(9)	(1)	(8)
Total interest income	<u>(1,224)</u>	<u>(1,180)</u>	<u>(44)</u>
Interest expense			
Deposits:			
Demand	(88)	(70)	(18)
Money market	(106)	(66)	(40)
Savings	3	1	2
Time	(163)	(180)	17
Total deposits	<u>(354)</u>	<u>(315)</u>	<u>(39)</u>
Customer repurchase agreements	(49)	(51)	2
Other borrowings	13	13	-
Total interest expense	<u>(390)</u>	<u>(353)</u>	<u>(37)</u>
Net interest income	<u>\$ (834)</u>	<u>\$ (827)</u>	<u>\$ (7)</u>

**Nine months ended September 30, 2012 and 2011**

Net interest income on a taxable equivalent basis increased \$12,269,000 or 45.5%, for the nine months ended September 30, 2012 compared to the comparable period in 2011. This was due primarily to the impact of the July 2011 merger with MidCarolina.

For the first nine months of 2012, the Company's yield on interest-earnings assets was 5.18% compared to 4.93% for the first nine months of 2011. The cost of interest-bearing liabilities was 0.91% compared to 1.17%. The interest rate spread was 4.27% compared to 3.76%. The net interest margin, on a fully taxable equivalent basis, was 4.47% compared to 3.98%. The increase in yield on earning assets was primarily driven by the impact of the MidCarolina merger and loan related accretion, which during the first half of 2012 included \$1,899,000 in additional accretion related to the resolution of several significant purchased credit impaired loans.

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

**Net Interest Income Analysis**  
For the Nine Months Ended September 30, 2012 and 2011  
(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2012	2011	2012	2011	2012	2011
<b>Loans:</b>						
Commercial	\$ 129,821	\$ 98,121	\$ 5,136	\$ 3,392	5.29%	4.62%
Real estate	679,375	516,165	31,720	22,093	6.23	5.71
Consumer	9,060	7,574	485	419	7.16	7.40
Total loans	<u>818,256</u>	<u>621,860</u>	<u>37,341</u>	<u>25,904</u>	<u>6.09</u>	<u>5.56</u>
<b>Securities:</b>						
Federal agencies	36,179	37,197	435	765	1.60	2.74
Mortgage-backed & CMOs	97,057	67,843	1,487	1,571	2.04	3.09
State and municipal	181,393	141,481	5,884	4,889	4.33	4.61
Other	11,598	6,538	332	193	3.82	3.94
Total securities	<u>326,227</u>	<u>253,059</u>	<u>8,138</u>	<u>7,418</u>	<u>3.33</u>	<u>3.91</u>
Deposits in other banks	<u>27,291</u>	<u>29,104</u>	<u>47</u>	<u>112</u>	<u>0.23</u>	<u>0.51</u>
Total interest-earning assets	<u>1,171,774</u>	<u>904,023</u>	<u>45,526</u>	<u>33,434</u>	<u>5.18</u>	<u>4.93</u>
Non-earning assets	<u>134,330</u>	<u>95,196</u>				
Total assets	<u>\$ 1,306,104</u>	<u>\$ 999,219</u>				
<b>Deposits:</b>						
Demand	\$ 144,284	\$ 122,497	154	167	0.14	0.18
Money market	168,212	111,801	414	382	0.33	0.46
Savings	78,808	66,138	88	69	0.15	0.14
Time	447,906	363,655	4,635	4,628	1.38	1.70
Total deposits	<u>839,210</u>	<u>664,091</u>	<u>5,291</u>	<u>5,246</u>	<u>0.84</u>	<u>1.06</u>
Customer repurchase agreements	46,297	45,452	125	244	0.36	0.72
Other short-term borrowings	-	45	2	-	-	0.47
Long-term borrowings	<u>37,413</u>	<u>28,820</u>	<u>868</u>	<u>973</u>	<u>3.09</u>	<u>4.50</u>
Total interest-bearing liabilities	<u>922,920</u>	<u>738,408</u>	<u>6,286</u>	<u>6,463</u>	<u>0.91</u>	<u>1.17</u>
Noninterest bearing demand deposits	205,446	133,008				
Other liabilities	20,415	4,619				
Shareholders' equity	<u>157,323</u>	<u>123,184</u>				
Total liabilities and shareholders' equity	<u>\$ 1,306,104</u>	<u>\$ 999,219</u>				
Interest rate spread					<u>4.27%</u>	<u>3.76%</u>
Net interest margin					<u>4.47%</u>	<u>3.98%</u>
Net interest income (taxable equivalent basis)			39,240	26,971		
Less: Taxable equivalent adjustment			<u>1,752</u>	<u>1,424</u>		
Net interest income			<u>\$ 37,488</u>	<u>\$ 25,547</u>		

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

	Nine Months Ended September 30		
	2012 vs. 2011		
	Interest Increase (Decrease)	Change Attributable to	
		Rate	Volume
Interest income			
Loans:			
Commercial	\$ 1,744	\$ 539	\$ 1,205
Real Estate	9,627	2,148	7,479
Consumer	66	(14)	80
Total loans	<u>11,437</u>	<u>2,673</u>	<u>8,764</u>
Securities:			
Federal agencies	(330)	(310)	(20)
Mortgage-backed	(84)	(632)	548
State and municipal	995	(315)	1,310
Other securities	139	(6)	145
Total securities	<u>720</u>	<u>(1,263)</u>	<u>1,983</u>
Deposits in other banks	(65)	(58)	(7)
Total interest income	<u>12,092</u>	<u>1,352</u>	<u>10,740</u>
Interest expense			
Deposits:			
Demand	(13)	(40)	27
Money market	32	(126)	158
Savings	19	5	14
Time	7	(954)	961
Total deposits	<u>45</u>	<u>(1,115)</u>	<u>1,160</u>
Repurchase agreements	(119)	(123)	4
Other borrowings	(103)	(347)	244
Total interest expense	<u>(177)</u>	<u>(1,585)</u>	<u>1,408</u>
Net interest income	<u>\$ 12,269</u>	<u>\$ 2,937</u>	<u>\$ 9,332</u>

**Noninterest Income**

All comparisons discussed below are between the third quarter of 2012 and the third quarter of 2011.

Noninterest income decreased to \$2,690,000 in 2012 from \$2,698,000 in 2011, a decrease of \$8,000 or 0.3%. The major factors impacting that change are discussed below.

Fees from the management of trusts, estates, and asset management accounts increased to \$926,000 in 2012 from \$921,000 in 2011, an increase of \$5,000 or 0.5%. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large impact on income.

Service charges on deposit accounts were \$414,000 in 2012 compared to \$575,000 in 2011, a decrease of \$161,000 or 28.0%. This was primarily the result of lower levels of overdraft and non-sufficient funds (NSF) fees and reduced service charge income.

Other fees and commissions were \$421,000 in 2012 compared to \$429,000 in 2011, a decrease of \$8,000 or 1.9%.

Mortgage banking income was \$615,000 in 2012 compared to \$374,000 in 2011, an increase of \$241,000 or 64.4%. Mortgage banking has benefited from the historically low interest rates.

Other income was \$314,000 in 2012 compared to \$399,000 in 2011, a decrease of \$85,000 or 21.3%. In 2011, the bank had a gain of \$114,000 on sale of bank real estate.

### **Noninterest Expense**

All comparisons discussed below are between the third quarter of 2012 and the third quarter of 2011.

Noninterest expense was \$8,880,000 for 2012 compared to \$8,564,000 for 2011, an increase of \$316,000 or 3.7%. The major factors impacting that change are discussed below.

Salaries were \$3,933,000 for 2012 compared to \$3,676,000 for 2011, an increase of \$257,000 or 7.0%. This increase was driven by an increase in the number of full time equivalent employees, including a temporary increase in the number of part time summer employees.

Employee benefits were \$780,000 for 2012 compared to \$731,000 for 2011, an increase of \$49,000 or 6.7%. Most of this increase was the result of higher health insurance expense.

Occupancy expense was \$929,000 for 2012 compared to \$916,000 for 2011, an increase of \$13,000 or 1.4%.

The Federal Deposit Insurance Corporation ("FDIC") assessment for deposit insurance was \$84,000 for 2012 compared to \$94,000 for 2011, a decrease of \$10,000 or 10.6%.

Bank franchise tax expense was \$173,000 for 2012 compared to \$206,000 for 2011, a decrease of \$33,000 or 16.0%. Franchise tax was reduced due to varying tax methods between Virginia and North Carolina.

Core deposit intangible amortization was \$421,000 for 2012 compared to \$545,000 for 2011, a decrease of \$124,000 or 22.8%. Core deposit amortization is computed on an accelerated method and will decrease year over year.

Foreclosed real estate, net, was \$412,000 for 2012 compared to income of \$32,000 for 2011, a \$444,000 increase. Net gains were realized from the sale of foreclosed property in the third quarter of 2011.

Merger related expenses were a (\$30,000) for 2012 compared to \$390,000 for 2011. The third quarter credit was the result of adjusting initial accrual estimates to actual expense.

Other expenses were \$2,178,000 for 2012 compared to \$2,038,000 for 2011, an increase of \$140,000 or 6.9%.

### **Income Taxes**

The effective tax rate for the third quarter of 2012 was 26.9% compared to 30.6% for the third quarter of 2011.

The effective tax rate for the nine months ended September 30, 2012 was 27.9% compared to 28.2% for the same period of 2011.

The effective tax rate is lower than the statutory rate of 35% due to income that is not taxable for Federal income tax purposes. The primary non-taxable income is that of state and municipal securities and industrial revenue bonds or loans.

## Fair Value Impact to net Income

The following table presents the impact for the three and nine month period ended September 30, 2012 of the accretable and amortizable fair value adjustments attributable to the MidCarolina merger on July 1, 2011 on net interest income and net income:

(in thousands)	Income Statement Effect	Remaining Premium/ (Discount) Balance on December 31, 2012	September 30, 2012		
			For the Three months ended	For the Nine months ended	Remaining Premium/ (Discount) Balance
<b>Interest income/(expense):</b>					
Loans	Income	\$ (15,908)	\$ 1,431	\$ 4,792	\$ (10,954) (1)
Accretable portion of loans acquired with deteriorated credit quality	Income	(1,056)	71	1,808	(3,115) (2)
Time deposits	Income	(110)	33	99	(11)
Time deposits - brokered	Income	(694)	104	312	(382)
Time deposits - CDARs	Income	22	-	-	-
FHLB advances	Expense	(11)	(5)	(17)	6
Trust preferred securities	Expense	(47)	(26)	(80)	33
<b>Net Interest Income</b>			<u>1,608</u>	<u>6,914</u>	
<b>Non-interest (expense)</b>					
Amortization of core deposit intangible	Expense	\$ 5,652	(327)	(1,231)	\$ 4,421
<b>Net non-interest expense</b>			<u>(327)</u>	<u>(1,231)</u>	
<b>Change in pretax income</b>			<u>\$ 1,281</u>	<u>\$ 5,683</u>	

(1) - Remaining discount balance includes \$162,000 in charge-offs against the mark

(2) - Remaining discount balance includes \$2,130,000 in reclassifications from the non-accretable difference

Accretion related to loans acquired with deteriorated credit quality includes \$1,899,000 in accretion income associated with loan payoffs during the nine month period.

The following table presents the actual effect for the quarter and nine month period ended September 30, 2011 of the accretable and amortizable fair value adjustments attributable to the MidCarolina merger on July 1, 2011 on net interest income and net income:



(in thousands)	Income Statement Effect	Premium/ (Discount) Balance on July 1, 2011	September 30, 2011		
			For the Three months ended	For the Nine months ended	Remaining Premium/ (Discount) Balance
<b>Interest income/(expense):</b>					
Loans	Income	\$ (20,740 )	\$ 1,217	\$ 1,217	\$ (19,523)
Accretable portion of loans acquired with deteriorated credit quality	Income	(1,663)	(17)	(17)	(1,680)
Time deposits	Income	(176)	33	33	(143)
Time deposits - brokered	Income	(902)	104	104	(798)
Time deposits - CDARs	Income	(22)	22	22	-
FHLB advances	Expense	(142)	(6)	(6)	(148)
Trust preferred securities	Expense	(2,218)	(25)	(25)	(2,243)
<b>Net Interest Income</b>			<b>1,328</b>	<b>1,328</b>	
<b>Non-interest (expense)</b>					
Amortization of core deposit intangible	Expense	\$ 6,556	(453)	(453)	\$ 6,103
<b>Net non-interest expense</b>			<b>(453)</b>	<b>(453)</b>	
<b>Change in pretax income</b>			<b>\$ 875</b>	<b>\$ 875</b>	

### Impact of Inflation and Changing Prices

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

### CHANGES IN FINANCIAL POSITION

#### BALANCE SHEET ANALYSIS

##### Securities

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

The available for sale securities portfolio was \$327,994,000 at September 30, 2012 compared to \$333,366,000 at December 31, 2011, a decrease of \$5,372,000 or 1.6%. At September 30, 2012, the available for sale portfolio had an amortized cost of \$311,563,000, resulting in a net unrealized gain of \$16,431,000.

The Company is aware of the historically low current interest rate environment and has elected to maintain an investment strategy of purchasing high quality taxable securities of relatively short duration and longer term, high quality, tax exempt securities, whose market values are not as volatile in rising rate environments as similarly termed taxable investments. The Company will attempt to deploy its cash to the maximum extent practical and prudent, consistent with its liquidity and asset liability strategy.

## Loans

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

Total loans were \$797,818,000 at September 30, 2012 compared to \$824,758,000 at December 31, 2011, a decrease of \$26,940,000 or 3.3%. The net decrease in loans is primarily related to expected reductions in the loan portfolio acquired in the MidCarolina merger. During the same period, on a standalone basis, the Virginia market was up \$6.2 million in loan balances or 1.2%.

Loans held for sale totaled \$8,118,000 at September 30, 2012, and \$6,330,000 at December 31, 2011, an increase of \$1,788,000 or 28.2%.

Management of the loan portfolio is organized around segments. Each segment is comprised of various loan types that are reflective of operational and regulatory management and reporting requirements. The following table presents the Company's loan portfolio by segment as of September 30, 2012 and December 31, 2011.

(in thousands)	<u>September 30, 2012</u>	<u>December 31, 2011</u>
Commercial	\$ 126,339	\$ 134,166
Commercial real estate:		
Construction and land development	50,688	54,433
Commercial real estate	356,692	351,961
Residential real estate:		
Residential	162,404	179,812
Home equity	95,008	96,195
Consumer	6,687	8,191
Total loans	<u>\$ 797,818</u>	<u>\$ 824,758</u>

## Allowance for Loan Losses

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

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

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

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

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

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

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, management cannot provide assurance that in any particular period the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current facts and circumstances at the time, including economic conditions, industry trends, and ongoing internal and external examination processes. In addition, the Company is developing historical charge-off and recovery data on new loan production in the North Carolina market and renewals of previously existing performing loans in that market. The allowance is also subject to regular regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance in comparison to peer banks.

At September 30, 2012, the allowance for loan losses was \$11,998,000 compared to \$10,529,000 at December 31, 2011. The allowance for loan losses as a percentage of loans was 1.50% and 1.28%, respectively. During the first nine months of 2012, the allowance for loan losses increased by \$1,469,000 or 14.0% and the loan portfolio contracted by \$26,940,000 or 3.3%. As noted above, the Company considers numerous quantitative and qualitative factors in determining its allowance adequacy. Since the July 2011 merger with MidCarolina, the Bank must also consider the velocity of accretion of the fair value, credit mark in relation to the amortization of the related loan balances. A large percentage of the Bank's North Carolina loan portfolio is commercial real estate, with relatively short maturities, with balloon payments, and relatively long amortization periods. This structure results in more rapid accretion of the mark than amortization of loan principal. While this is not a proximate cause in and of itself for additional provision, it does result in an increased volume of loans that must be evaluated for potential loss as they are renewed, on current market terms, and become part of the regular portfolio.

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

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

	<b>Nine Months Ended September 30, 2012</b>	<b>Year Ended December 31, 2011</b>
Balance at beginning of period	\$ 10,529	\$ 8,420
<b>Charge-offs:</b>		
Construction and land development	191	529
Commercial real estate	281	173
Residential real estate	550	641
Home equity	54	230
Total real estate	1,076	1,573
Commercial and industrial	560	163
Consumer	46	127
Total charge-offs	1,682	1,863
<b>Recoveries:</b>		
Construction and land development	84	36
Commercial real estate	367	270
Residential real estate	134	40
Home equity	20	10
Total real estate	605	356
Commercial and industrial	681	373
Consumer	66	73
Total recoveries	1,352	802
Net charge-offs (recoveries)	330	1,061
Provision for loan losses	1,799	3,170
Balance at end of period	\$ 11,998	\$ 10,529

The provision for loan losses for the nine month period in 2012 was \$1,799,000 and the provision for the year ended December 31, 2011 was \$3,170,000. The ongoing provision expense is determined in recognition of the larger size, complexity, and risk of the loan portfolio after the MidCarolina merger.

Net loans charge-offs totaled \$330,000 for the nine month period in 2012 and \$1,061,000 in 2011. Annualized net charge-offs to average loans during the same periods totaled 0.05% and 0.16%, respectively.

## Asset Quality Indicators

The following table provides qualitative indicators relevant to the Company's loan portfolio for the quarter and year indicated below.

### Asset Quality Ratios

	<u>September 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Allowance to loans	1.50%	1.28%
Net charge-offs to allowance (1)	3.67	10.08
Net charge-offs to average loans (1)	0.05	0.16
Nonperforming assets to total assets	1.08	1.46
Nonperforming loans to loans	0.99	1.66
Provision to net charge-offs (1)	726.87	298.77
Provision to average loans (1)	0.30	0.47
Allowance to nonperforming loans	153.53	76.74

(1) - annualized

### Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings that are not on nonaccrual. Nonperforming loans to total loans were 0.98% at September 30, 2012 and 1.66% at December 31, 2011.

Nonperforming assets include nonperforming loans and other real estate. Nonperforming assets represented 1.08% of total assets at September 30, 2012, down from 1.46% at December 31, 2011. Included in nonperforming assets were \$1,860,000 in troubled debt restructurings at September 30, 2012 and \$656,000 at December 31, 2011.

It is the policy of the Company that any loan that becomes 90 days past due will, in most cases, be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The \$7,815,000 in nonaccrual loans shown on the following table includes \$2,421,000 in impaired loans. The remainder represents loans which were not deemed impaired because, based on performance and existing circumstances, management did not believe loss was probable and, accordingly, did not classify these loans as impaired. These loans are exclusive of \$24,633,000 in loans acquired from MidCarolina with deteriorated credit quality.

The following table presents the Company's nonperforming assets.

**Nonperforming Assets**  
(in thousands)

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Nonaccrual loans:		
Real estate	\$ 6,656	\$ 11,654
Commercial	1,159	1,820
Consumer	-	49
Total nonaccrual loans	<u>7,815</u>	<u>13,523</u>
Loans past due 90 days and accruing interest:		
Real estate	-	197
Total past due loans	<u>-</u>	<u>197</u>
<b>Total nonperforming loans</b>	<b><u>7,815</u></b>	<b><u>13,720</u></b>
Foreclosed real estate	<u>6,259</u>	<u>5,353</u>
<b>Total nonperforming assets</b>	<b><u>\$ 14,074</u></b>	<b><u>\$ 19,073</u></b>

Impaired Loans

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

**Impaired Loans**  
(in thousands)

	<b>June 30, 2012</b>	<b>December 31, 2011</b>
Accruing	\$ 633	\$ 313
Nonaccruing	1,788	2,925
Total impaired loans	<u>\$ 2,421</u>	<u>\$ 3,238</u>

Included in the impaired loan totals were \$1,860,000 in troubled debt restructured loans at September 30, 2012 and \$656,000 at December 31, 2011.

**Other Real Estate Owned (Foreclosed Assets)**

Foreclosed assets were carried on the consolidated balance sheets at \$6,259,000 and \$5,353,000 as of September 30, 2012 and December 31, 2011, respectively. Foreclosed assets are initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the allowance for loan losses at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals.

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

**Other Real Estate Owned**  
(in thousands)

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Construction and land development	\$ 3,815	\$ 3,001
1-4 family residential	1,696	1,267
Commercial real estate	748	1,085
	<u>\$ 6,259</u>	<u>\$ 5,353</u>

**Deposits**

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$1,052,427,000 at September 30, 2012 compared to \$1,058,754,000 at December 31, 2011, a decrease of \$6,327,000 or 0.6%.

**Shareholders' Equity**

The Company's capital management strategy is to be classified as "well capitalized" under regulatory capital ratios and provide as high as possible total return to our shareholders.

Shareholders' equity was \$162,045,000 at September 30, 2012 compared to \$152,829,000 at December 31, 2011, an increase of \$9,216,000 or 6.0%.

The Company paid cash dividends of \$0.23 per share during the third quarter of 2012. During that same quarter the basic and diluted earnings were \$0.46 per share. The Company paid cash dividends of \$0.69 per share for the first nine months of 2012. During that same period the basic and diluted earnings were \$1.54 per share.

Banking regulators have defined minimum regulatory capital ratios that the Company and its banking subsidiary are required to maintain. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholders' equity and trust preferred capital notes, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the combination of Tier I and Tier II capital. Another regulatory indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At September 30, 2012, the Company's Tier I and total capital ratios were 15.26% and 16.51%, respectively. At December 31, 2011, these ratios were 14.36% and 15.55%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 11.04% and 10.32% at September 30, 2012 and December 31, 2011, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

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

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

## Liquidity

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

Liquidity sources include cash and amounts due from banks, deposits in other banks, loan repayments, increases in deposits, lines of credit from the Federal Home Loan Bank of Atlanta (“FHLB”) and the Federal Reserve Bank’s discount window, federal funds lines of credit from two correspondent banks, and maturities and sales of securities. Management believes that these sources provide sufficient and timely liquidity.

The Company has a line of credit with the FHLB, equal to 30% of the Company’s assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. At September 30, 2012, principal advance obligations to the FHLB consisted of \$10,111,000 in fixed-rate, long-term advances compared to \$10,206,000 in long-term advances and \$3,000,000 in short-term advances at December 31, 2011. The Company also had outstanding \$72,700,000 in letters of credit at September 30, 2012 and \$72,000,000 in letters of credit at December 31, 2011. The letters of credit provide the Bank with alternate collateral for securing public entity deposits above Federal Deposit Insurance Corporation insurance levels, thereby providing less need for collateral pledging from the securities portfolio.

The Company had fixed-rate term advance borrowing contracts with the FHLB as of September 30, 2012, with the following final maturities:

<u>Amount</u>	<u>Maturity Date</u>
\$ 225,000	March 2014
9,886,000	November 2017
<u>\$ 10,111,000</u>	

The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 and \$10,000,000, and has access to the Federal Reserve Bank’s discount window. There were no amounts outstanding under these facilities at September 30, 2012.

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



## Off-Balance-Sheet Activities

The Company enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. Other than subsidiaries to issue trust preferred securities, the Company does not have any off-balance sheet subsidiaries. Off-balance sheet transactions were as follows (in thousands):

	<b>September 30,</b>	<b>December 31,</b>
	<b>2012</b>	<b>2011</b>
Commitments to extend credit	\$ 168,710	\$ 191,957
Standby letters of credit	4,541	2,961
Mortgage loan rate-lock commitments	14,168	5,387

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

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

#### Market Risk Management

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

#### *Interest Rate Risk Management*

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

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

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position is asset sensitive. The simulation projects that if rates increase over a 12 month period by one percent, net interest income is expected to increase by 3.7%. Management has no expectation that market rates will decline in the near term, given the prevailing economy.

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

### ITEM 4. CONTROLS AND PROCEDURES

#### *Disclosure Controls and Procedures*

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

## PART II

### OTHER INFORMATION

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

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

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

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

**Item 6. Exhibits**

- 11.0 Refer to EPS calculation in the Notes to Financial Statements
- 31.1 Section 302 Certification of Charles H. Majors, Chairman and Chief Executive Officer
- 31.2 Section 302 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer
- 32.1 Section 906 Certification of Charles H. Majors, Chairman and Chief Executive Officer
- 32.2 Section 906 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AMERICAN NATIONAL BANKSHARES INC.

/s/ Charles H. Majors

Charles H. Majors  
Chairman and Chief Executive Officer

Date – November 9, 2012

/s/ William W. Traynham

William W. Traynham  
Senior Vice President and  
Chief Financial Officer

Date – November 9, 2012

